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CIS

INTEREST RATES AND BUSINESS CREDIT NEEDS

HEARINGS

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

INTEREST RATES AND BUSINESS CREDIT NEEDS

PART 1

SEPTEMBER 23 AND 24, 1981

Printed for the use of the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE
87-591 O WASHINGTON : 1981

S721-4

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INTEREST RATES AND BUSINESS CREDIT NEEDS

WEDNESDAY, SEPTEMBER 23, 1981

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The committee met, pursuant to notice, at 9:10 a.m., in room 424, Russell Senate Office Building, Hon. Lowell Weicker, Jr., chairman of the committee, presiding.

Present: Senators Weicker, D'Amato, Nunn, Huddleston, Baucus, and Tsongas.

Also present: Robert J Dotchin, staff director; James J. O'Connell, economist; G. Thomas Cator, minority economist; W. P. Goodwin, Jr., minority special counsel; and Margaret M. Broadbin, hearing clerk.

STATEMENT OF HON. LOWELL WEICKER, JR., A U.S. SENATOR FROM THE STATE OF CONNECTICUT, AND CHAIRMAN, COMMITTEE ON SMALL BUSINESS

Senator **WEICKER**. This morning the Small Business Committee is opening 2 days of hearings on the problem of high interest rates and their relation to business credit needs, particularly small business.

While there have been some recent hopeful signs, the prime rate is still up near 20 percent, and mortgage rates stand at 17 percent. It is no wonder that the bankruptcies are running almost 50 percent above last year, that new construction of single-family houses is at the lowest point since the Government began keeping records, and that auto sales are one-third below the 1978 level. Literally thousands of small businesses face extinction because of staggering interest rates.

Persistent high interest rates are a millstone around the neck of our economy. They have the potential of dragging down private capital investment, which is the linchpin of the supply-side economic recovery we so desparately need. There is no doubt that if our economy goes into a tailspin because of high interest rates, we can forget about a new capital investment boom and about a balanced budget in 1984. High interest rates have the power to destroy the President's economic recovery program before it gets off the ground.

In my judgment, we must have a significant downward movement of interest rates this fall if an unraveling of our economic policy is to be averted.

There is, to be sure, a crisis of confidence on the part of the financial community. Investors in fixed-income securities have been burned so badly in the past by good intentions gone wrong that they are, and should be, circumspect about Government promises based on untested theories.

Wall Street pragmatists should not be condemned because they cannot make the great leap of faith over to the supply-side theology. Economic miracles aside, there is still no such thing as a free lunch.

I think these investors, including employee pension funds, insurance companies, banks and bank trust departments, and individuals, are right to be skeptical. After all, they are charged with safeguarding individuals' purchasing power in long-term investments.

The question for this Congress is: Can we give them some tangible evidence of our resolve to put the Government's fiscal house in order? I think we can, and I think we must.

Accordingly, I am prepared to state that the planned arms buildup may have to be stretched out further. Specifically, planned total defense outlays in fiscal year 1982–84 of $667 billion may need to be reduced by more than the token $13 billion recommended by the President. I do not think we can rule out even a 5-percent cut spread over 3 years, or $33 billion. This would still permit hefty increases in our national security.

This course of action would be far more acceptable than cutting social security benefits, which are based upon a contract between the people and their Government. The last thing I want is for this Senate to be stampeded into cutting social security. I do not think it is fair to threaten the lives of older people while the mammoth arms buildup gets off with just a nick.

Obviously, we have issues of profound importance before us today and tomorrow. I hope our witnesses will be able to educate us as to why rates have hung up so high and for so long, give us some idea of the prospects for interest rates, and advise us as to what needs to be done to bring about a downward drift in interest rates.

[The prepared statement of Senator Sasser follows:]

Statement of Hon. James R. Sasser, a U.S. Senator From the State of Tennessee

Mr. Chairman, we are here today to examine the impact of high interest rates on small business. It is fitting that we do this because of the unique role that small business plays in our economy and also because of the disproportionate burden that high rates place on small firms.

As the members of the committee are well aware, it is the small business that creates the vast majority of the jobs in our economy and it is the small firm that does more than its share in the way of innovation. Small business is also the largest employer and is the fastest growing sector of our economy.

At the same time, small business has a tremendous problem obtaining capital. Unlike its larger competitors, it is virtually prohibited from selling stock to raise funds, and small firms usually do not generate the kind of cash flow necessary to rely upon retained earnings.

They are left with borrowing. Whether they want to invest in their business or whether they are borrowing simply to restock inventories, they are forced to go to their local bank and borrow funds at prevailing rates. This usually means they will pay two points over the prime rate or more. With the prime at or near 20 percent, no one who has substantial borrowing needs, can stay in business for very long.

And this is what we have seen happen all across the country: credit sensitive businesses going under.

Some 2,600 auto dealers have closed their doors as the interest on their their floor-plan loans climbed higher and higher. The national association of homebuilders estimates that as much as one-third of the homebuilding work force has left the field due to the depression in housing caused by high interest rates.

Economy wide the story is not much different. Overall business failures so far in 1981 are running 41 percent ahead of the same period last year. Business and farm bankruptcy filings are up significantly as well. In Tennessee alone, these bankruptcy filings are up some 39 percent over last year.

It is apparent, Mr. Chairman, that the high interest rate policy has not worked. In fact, it has been a major obstacle to renewed economic growth.

The stock market has slipped dramatically and activity in the bond market has all but ceased. Though the demand for business credit remains strong, little of our Nation's capital is being put into long-term investment.

Currently, economic experts indicate that the Federal Reserve Board's monetary targets will permit a nominal rate of GNP growth of some 10 percent. This is significantly different from the 12 or 13 percent that is forecast by the administration.

Consequently we have tax and spending cuts designed to put more money into the private sector to promote economic growth while the Federal Reserve Board follows a policy of holding down the money supply and shutting off economic growth. Thus, we have a fundamental contradiction in our economic policy. We want economic growth, but we cannot make credit available to help promote that long-term growth.

In short, high interest rate policies are not promoting the economic growth this country so badly needs. The Fed's interest rate policy has received a vote of no confidence from American business.

Mr. Chairman, there is another aspect of the high interest rates we are seeing that I want to comment upon, and that is the relationship they bear to the rate of inflation. Historically, there has been a 2 to 3 point spread between the rate of inflation and the prime rate. This has reflected the real cost of borrowing money.

But now we find that the inflation rate, as measured by the monthly Consumer Price Index, dropping as low as 1.2 percent in one case last year, but the prime rate has never dropped below 11 percent since the Federal Reserve Board instituted its new money supply policy in October of 1979. Now it is not uncommon to see a 7 to 10 point spread between the consumer price index and the prime rate. The real cost of money has skyrocketed and our economy suffers as a result.

Finally, these policies will make it impossible for us to balance the budget by 1984.

The Congressional Budget Office recently reported that they expect interest rate outlays to be $40 billion more than administration projections due to the administration's own unrealistic projections of interest rates through 1984.

And we know from other CBO economic projections that if GNP growth falters because of high interest rates by just 1 point below administration projections, we will have about $38 billion less in federal revenue between now and 1984.

Adding the two together we face a situation where the cumulative budget deficits will be increased by $78 billion between now and 1984.

When I see that, I am not surprised that we will have a hard time balancing the budget by 1984 unless interest rates come down.

Mr. Chairman, we simply cannot have an economic policy which seeks to bolster American business and consumers by cutting spending and taxes while we have a monetary policy which holds down economic growth by tight money. American business stands ready to rebuild our economy and make it grow again. American consumers stand ready to buy in a stronger economy.

But that will not occur unless we turn away from this present policy of high interest rates.

Senator **Weicker**. Our first witness is our former colleague on the committee and good friend, Senator Larry Pressler.

STATEMENT OF HON. LARRY PRESSLER, A U.S. SENATOR FROM THE STATE OF SOUTH DAKOTA

Senator **Pressler**. Thank you, Mr. Chairman.

I shall be very brief and summarize because I know you have a number of witnesses, plus the fact that I was going to testify tomorrow morning and, depending on votes, have to be out of town. First of all, I thank you for hearing me this morning.

Rather than reading my testimony, let me just summarize by saying, first of all, that there are a lot of forces in our country that like high interest rates. I think that the great banks and of course the Government make somewhat of a profit off of high interest rates, but also people who are in a capital favorable position like high interest rates because they can collect interest on loans, their returns are higher, and if they go out to buy something, a piece of property or a company, they can buy it cheaper because the price is lower because there is less competition for it.

For example, in the housing market, there has been a decline in values in some areas because the average person cannot get a loan or cannot pay the interest to buy a house. In some instances, people who have a great deal of money are able to buy them cheaper than they otherwise would be able to.

The point is that there are some very powerful forces that like high interest rates. Wright Patman used to do law review articles analyzing the forces in our society that like high interest rates. He said that that was OK, that they had their points of view, but that they should not all be on the Federal Reserve Board.

It is my feeling that the Federal Reserve Board is made up of people who like high interest rates, whose backgrounds are that way. If you read the biographies of the Federal Reserve Board, they are all from big banks or are economists who have been tied in with large companies. There are not any small businessmen or agricultural people on it.

Therefore, it is very proper—I commend you, Mr. Chairman—for holding these hearings in the Small Business Committee because it is small business that is hurt the worst. Indeed, I have some statistics on how small business has been hurt in my State. For example, 10 percent of all franchised used car dealerships in my State of South Dakota have gone out of business.

In any event, I have been talking about the effects of high interest rates for some months. It is not just a recent thing with me. I took three steps. I think they summarize my position.

First of all, I wrote the President a letter and I raised it in the Republican Senators' meeting with the President as early as last May that those high interest rates are the Achilles heel of the Reagan administration's economic program, and that it will cause a huge budget deficit because it is slowing revenues down by lessening activities of small business, agriculture, housing, automobiles, and many other areas. In your statement, you have restated that very well.

Second of all, I have proposed legislation to shorten the terms of the board of governors of the Federal Reserve. They have 14-year terms. I think they should have 7-year terms. Senators have 6-year terms. This would be giving them a longer term than we have. This would give the President an opportunity to make an appointment to the Federal Reserve every year rather than every 2 years.

Also, my legislation would require a diversity of backgrounds in the board of governors. I suggest someone from the small business community and someone from the agricultural community. This would not necessarily have to be bound that much, but the point is, if you look at the biographies of the board of the Federal Reserve, they all come out of the same group, the group that very frankly likes high interest rates.

Also, I am an advocate of extending the Credit Control Act to give the President power to give different levels of interest rates to different segments of the economy. For example, I think it is wrong that in the recent purchase of Conoco by Du Pont the amounts of loans and credits are available for those huge corporate mergers, but at the same time we do not have money available for small business, housing, and many of the other areas.

Those are some legislative initiatives. I must say I have gained some cosponsors for my legislation to revise the Federal Reserve Board. I think that proposal is a modest one. I certainly do not propose to do away with it, but I do think we need to make it more responsive to Congress and to the people.

The third step I took is not relevant to this committee, but I wrote to the chairman of my political party and said that if we do not do something about high interest rates, we could very well lose control of the Senate in the 1982 elections, and we could very well lose the opportunity we have politically. That is not really a concern of this committee, but I think it is something that we should be well aware of.

Let me conclude by saying that three leading economists have predicted that interest rates could go up to 25 percent next year, as reported in both Time Magazine and Newsweek. I have their quotes here.

If we do see interest rates at between 20 and 25 percent next year, it will be a disaster for small business, agriculture, and the type of economy that I represent and which I think makes up the backbone of the American economy. I think these interest rates are the greatest threat to small business. I commend the committee for holding these hearings.

I submit my written statement for the record. Thank you.

[The prepared statement of Senator Pressler follows:]

TESTIMONY BY SENATOR LARRY PRESSLER
BEFORE THE
SENATE SELECT COMMITTEE ON SMALL BUSINESS
HEARINGS ON THE EFFECT OF HIGH INTEREST RATES
SEPTEMBER 23, 1981

MR. CHAIRMAN: I APPRECIATE THIS OPPORTUNITY TO TESTIFY BEFORE THE SENATE SELECT COMMITTEE ON SMALL BUSINESS REGARDING HIGH INTEREST RATES. I COMMEND THE CHAIRMAN AND COMMITTEE MEMBERS FOR PROVIDING THIS OPPORTUNITY TO DISCUSS THIS MATTER OF CRUCIAL IMPORTANCE TO THE SMALL BUSINESS COMMUNITY.

HIGH INTEREST RATES ARE DEVASTATING THE SMALL BUSINESSES IN MY STATE AND ACROSS THE NATION. IN THE PAST YEAR AND A HALF, 10% OF ALL THE FRANCHISED USED CAR DEALERSHIPS IN MY STATE OF SOUTH DAKOTA HAVE GONE OUT OF BUSINESS, PRIMARILY BECAUSE OF INTEREST RATES THAT CONSUMERS ARE UNABLE OR UNWILLING TO PAY. THE HOUSING INDUSTRY IN MY STATE IS AT A VIRTUAL STANDSTILL. FARMERS ARE FOREGOING INCREASING THEIR LIVESTOCK HERDS BECAUSE THEY CANNOT POSSIBLY RETURN A PROFIT WHEN THEY MUST BORROW MONEY AT UPWARDS OF 19%.

I AM ONE WHO BELIEVES THAT THE FEDERAL RESERVE IS INCREASING OUR RATE OF INFLATION BY NOT TAKING ACTIONS TO LOOSEN THE MONEY SUPPLY AND THUS BRING DOWN INTEREST RATES. HISTORICALLY WE HAVE HAD INTEREST RATES AT ABOUT THREE OR FOUR PERCENT ABOVE INFLATION. NOW, HOWEVER, WE ARE EXPERIENCING INFLATION AT SOMEWHERE AROUND 10% ANNUALLY WITH INTEREST RATES OF 18, 19 AND 20%.

I FEAR THAT THE FEDERAL RESERVE POLICIES MAY DO PERMANENT DAMAGE TO THE SMALL BUSINESS SECTOR OF OUR ECONOMY IF ACTION IS NOT TAKEN SOON. IT IS TOO LATE TO TAKE ACTION WHEN OUR COUNTRY IS FULL OF CORPORATE FARMS AND CONGLOMERATE-OWNED BUSINESSES BECAUSE THESE WERE THE ONLY ONES CAPABLE OF OBTAINING LOAN FUNDS.

I URGE THE COMMITTEE TO QUESTION THE WITNESS FROM THE FEDERAL RESERVE BOARD TESTIFYING TODAY, WHY BANKS ARE NOT DISCOURAGED FROM MAKING LOANS FOR HUGE CORPORATE MERGERS SUCH AS THE RECENT PURCHASE OF CONOCO BY DUPONT, AND ENCOURAGED TO MAKE LOANS AVAILABLE AT REASONABLE RATES FOR PRODUCTIVE USES OF CREDIT. THE DUPONT TRANSACTION--WHICH CREATED NOT ONE NEW JOB--GOBBLED BILLIONS OF DOLLARS OF AVAILABLE CREDIT THAT MIGHT BETTER HAVE BEEN SPENT FINANCING HOUSING OR ASSISTING OTHER SMALL BUSINESSES THAT WOULD KEEP MONEY WITHIN THE LOCAL COMMUNITY. SUCH UNPRODUCTIVE USES OF CREDIT ARE DIFFICULT TO JUSTIFY WHEN OTHERS SEEKING CREDIT TO SUSTAIN THEIR LIVELIHOODS ARE BEING TURNED AWAY.

AFTER THE AUGUST HOME WORK PERIOD, I INTRODUCED S. 1609, WHICH AMENDS THE FEDERAL RESERVE ACT TO MAKE IT MORE RESPONSIVE TO THE AMERICAN PEOPLE. MY BILL DOES THIS BY REQUIRING THAT PERSONS FROM THE SMALL BUSINESS AND AGRICULTURE SECTORS OF THE ECONOMY BE APPOINTED TO THE FEDERAL RESERVE BOARD. THE BILL ALSO SHORTENS THE TERMS OF FEDERAL RESERVE GOVERNORS FROM THE CURRENT 14 YEARS TO 7 YEARS. IT PROVIDES FOR MEMBERS OF CONGRESS TO SERVE AS EX OFFICIO MEMBERS OF THE BOARD AND REQUIRES THE FEDERAL RESERVE TO KEEP RECORDS OF LOANS BY SIZE OF BUSINESS SO THAT WE CAN MORE ACCURATELY DETERMINE THE EFFECT THAT

INTEREST RATES HAVE ON VARIOUS SIZED BUSINESSES. I HAVE BI-PARTISAN SUPPORT FOR THIS BILL AND PLAN TO CONTINUE MY EFFORTS TO RESTRAIN INTEREST RATES.

AGAIN, MR. CHAIRMAN, I THANK YOU FOR THE OPPORTUNITY TO TESTIFY ON THIS URGENT PROBLEM OF HIGH INTEREST RATES. I WILL CONTINUE MY EFFORTS TO BRING RELIEF TO THE SMALL BUSINESS PERSONS WHO ENSURE DIVERSITY AND COMPETITION IN THE AMERICAN MARKETPLACE.

Senator **WEICKER**. Senator Pressler, thank you very much.

Are there any questions?

Senator **NUNN**. No questions, but thank you very much, Senator.

Senator **WEICKER**. Before we hear from Mr. Jerry Jordan, member of the President's Council of Economic Advisers, we have been joined by the ranking member, Senator Nunn, and my good friend Senator D'Amato. If either of my colleagues cares to make a statement, we would be delighted to have it.

STATEMENT OF HON. SAM NUNN, A U.S. SENATOR FROM THE STATE OF GEORGIA

Senator **NUNN**. Mr. Chairman, I do not want to take up a lot of time, but I do think these hearings are very important and I do have a brief opening statement I would like to make.

I first want to thank you, Mr. Chairman, for holding these 2 days of hearings on interest rates and business credit needs. When you and I talked last July about having these hearings, I had hoped at that time that by today we would be performing in our economy with renewed vigor in the private sector, with less inflation, more jobs, and lower interest rates. As we all know, that has not happened.

The administration's economic program has been enacted, but regretably, the financial markets have been responding adversely. We all know the bond market is severely depressed, the stock market has lost more than 175 points since its high point last April, and until recently, very recently, there has been no relief from exceedingly high interest rates. Of course, they do remain very, very high by any standard today.

More importantly, there is going to have to be a lot more improvement in the financial markets and the interest rate picture before we have turned the corner and are headed for economic recovery. A principal reason, in my view, for this reaction is the fear on the part of many investors in this country in the financial markets of continued very large deficits.

The Congressional Budget Office projects a $65 billion deficit in 1982, Data Resources a $62.5 billion deficit, and Townsend & Greenspan a $67.3 billion deficit. I know we will be hearing from Mr. Greenspan later today. Each projection is far larger than the administration's projection.

Further spending cuts to reduce the deficit are necessary but will prove difficult. Once we take into account the spending for national defense, outlays for social security and retirement programs, medicare, and other entitlement programs, plus interest on the debt and veterans' benefits, all of this together accounts for about three-fourths of the overall 1982 budget.

That leaves only approximately $180 billion after you take those programs into account from which further budget cuts can be made. Those cuts would have to come either from some very worthwhile programs like the agricultural programs, mass transit, sewage treatment, education, or they will have to come from entitlements and the defense sector.

Either means of reducing spending is going to prove more and more difficult in the future, although certainly I will do what I can, as I am sure most of the members of this committee will, to support whatever cuts make sense for our overall economy.

There are a few positive benefits in the economy. The United States is becoming less dependent on foreign oil. I think that is one of the things that is keeping our economy from being in worse shape than it is today. That is causing the oil prices to fall to some extent, or at least to hold steady.

We also have a very abundent harvest, which is holding the line on food prices. Both of those are very positive signs.

However, what worries me the most is the decreasing likelihood of further massive budget cuts. It is becoming more and more apparent that if we do not make massive new budget cuts, which is less likely every day, we are going to be following two inconsistent policies: an expansionary fiscal policy and a highly restrictive monetary policy.

Even if the Congress accepted the President's newly proposed budget cuts and tax increases, the recently enacted tax cuts would exceed the budget cuts by nearly $35 billion over the next 3 years. Yet monetary policy seemingly will allow for something like 5 percent to 8 percent nominal economic growth next year.

One of the things I want to explore with our witnesses this morning, Mr. Chairman, is how we hold the line on money growth and at the same time project very large increase in real economic growth. I want to get some explanations of that, particularly from the administration witnesses.

This conflict, or at least this seeming conflict, between fiscal and monetary policy is like trying to go down a road with horses pulling from both ends of the wagon. We are going nowhere, and we may pull the wagon apart while we try.

I know of no economic policy which says you can stimulate the economy through fiscal policy and at the same time use monetary policy to restrain inflation. One of these policies has to give.

I thank you, Mr. Chairman, for holding these hearings. We all know the small business community is in dire straits. We all know the farming and agricultural community is in dire straits. I hope that these hearings will help guide us as members of the committee, and hopefully the administration and the Federal Reserve Board, in seeking to coordinate fiscal and monetary policy to a much greater degree than now exists and that has existed in the past.

I look forward to hearing from our witnesses this morning, Mr. Chairman. Again, I thank you for holding these hearings.

Senator **WEICKER**. Thank you very much, Senator Nunn.

Senator D'Amato?

STATEMENT OF HON. ALFONSE M. D'AMATO, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator **D'AMATO**. Thank you, Mr. Chairman.

I believe you do a great service today in focusing on the problems of high interest rates as they impact on our community and our economic lifeblood, the small business entrepreneur, who is being squeezed out of business by what I consider to be an ill-advised monetary policy designed to control inflation, designed to put the squeeze on the so-called expansion of the monetary system, but which has done little in that direction while it has exacerbated the credit market to the point where it is counterproductive.

That is my opinion. I continue to believe it. I believe that the Federal Reserve is being unduly restrictive. We have been listening to the necessity of keeping a tight money policy to avoid runaway inflation and the resolve of the Federal Reserve to continue this practice.

I intend to pose the question when we see Mr. Volcker at a future date of why is it that 18 months ago we could have financial manipulation, monetary manipulation, and go from 20 percent interest rates down to 12 percent—we certainly are not asking for that—and then why is it at this point in time we see a situation where there is absolutely no input, apparently, from the administration, desirous of beginning to bring the interest rate down.

I think there is a dual standard with Mr. Volcker in what he could do last year and will do this year. We are not asking him to do it exactly the same this year, but we should certainly begin to ease the credit restrictions and the tight money policy that the Federal Reserve has clamped on. I think it is unduly restrictive, and it is doing much more damage to the economy than many of the other factors, including the deficits that we face.

Senator **WEICKER**. Thank you very much, Senator D'Amato.

Senator Tsongas?

STATEMENT OF HON. PAUL E. TSONGAS, A U.S. SENATOR FROM THE STATE OF MASSACHUSETTS

Senator **TSONGAS**. Thank you, Mr. Chairman.

I find the current furor over high interest rates intriguing when you consider what we have already passed out of the Senate this year.

I had a group of small businessmen who are involved in the auto industry come in and see me last week demanding lower interest rates. "We would like you to lower them," they said. I said I would be glad to do it.

I asked them what did they do on Kemp-Roth. They said they supported it. Then how do you feel about the massive increases in defense spending? We support that, too.

You know, at some point there has to be an accounting. If one wants to have lower interest rates, one has to understand how the system operates in its totality. You cannot have a massive reduction in taxes and massive increases in defense spending without having the kinds of deficits that have been spoken about. If you have the Government intruding to that extent in the money markets, you are going to have interest rates.

It does no good to come back and see Members of Congress and suggest that somehow the problem can be resolved. Nor do I think that the Federal Reserve is primarily responsible. Clearly, they are an important part of the same package, but blaming the Fed alone for high interest rates is oversimplifying.

Rather than go on, I would ask, Mr. Chairman, that a statement I made on June 2, 1980, when I was trying to keep the Credit Control Act from being repealed last year be included in the record. I think it makes for rather interesting reading some 15 months later.

Second, I have two articles from the Wall Street Journal, one from this morning, a lead article entitled "Many Analysts Grow Gloomier on Outlook for Interest Rates," and finally a rather interesting article of a week ago Friday which spoke about Wall Street's unhappiness with having supported the Kemp-Roth component of the tax cut in exchange for a provision in the law which was excluded. Now they feel betrayed.

I think we are all in this thing together. Many of the people have spoken out against high interest rates ought to spend a few moments in retrospection about the policies they have supported these past 8 months and understand that we have met the enemy and he is us.

Thank you very much, Mr. Chairman.

Senator **WEICKER**. Thank you very much, Senator Tsongas.

The articles will be included in the record at this point.

[Material follows:]

[From the Wall Street Journal, Sept. 23, 1981]

CREDIT CLOUD—MANY ANALYSTS GROW GLOOMIER ON OUTLOOK FOR INTEREST RATES—THEY SEE NO SHARP DECLINE THROUGH 1982, CITE NEEDS OF TREASURY, BUSINESS—WILL THE FED CHANGE COURSE?

(By Lindley H. Clark, Jr.)

Interest rates have been edging lower in the past few days, and economists think that they may move lower still over the near term. But analysts generally see the trend as temporary and expect rates through most or all of 1982 to stay high—and at levels higher than they anticipated until just recently.

Part of the reason is the financial markets' continuing skepticism about the Reagan administration's economic program. The President will address the nation on television tomorrow night in an attempt to persuade the skeptics, but indications are that they will take a lot of persuading.

The analysts remain pessimistic even though early this week major commercial banks reduced their prime rate—the rate posted as the charge to their best corporate customers—to 19½ percent from 20 percent. Also, on Monday, the Federal Reserve System cut the penalty surcharge that it imposes on big banks that borrow frequently from the Fed to three percentage points from four.

GENERAL VIEW

But Henry Kaufman, chief economist at the brokerage firm of Salomon Brothers, says, "This respite isn't likely to endure." He expects heavy Treasury and corporate borrowing later this year to put upward pressure on interest rates. Jack W. Lavery, chief economist at Merrill Lynch Economics, thinks that the Fed will continue to slow monetary growth and that "this makes a substantial, sustained decline in rates over the short term quite difficult." And Norman Robertson, chief economist at Pittsburgh's Mellon Bank, sees both short-term and long-term rates falling a bit next year, but "on the average," he adds, "rates in 1982 may not be very different from this year's level."

In the past few days, nearly all economists have raised their interest-rate forecasts They cite growing evidence that the Fed will stick to its policy of monetary restraint and that larger-than-expected federal deficits will require heavy Treasury borrowing. In addition, the economy has shown a surprising ability to deal with high interest rates; the result is a lessening of prospects for the sort of deep recession that would curb private borrowing and drag them down. This is a recession, it so far hasn't been harsh enough to deter private borrowing.

According to Bank of New York, demand for short-term business credit in August set a record for the fifth consecutive month. "The magnitude of the gain was obviously beyond seasonal proportions and was in part attributable to loan-commitment takedowns stemming from a major corporate acquisition early in the month," the bank said. "Nonetheless, even if merger-induced borrowings are excluded, short-term credit demands are still rising at a rapid pace during August."

Richard S. Peterson, senior vice president of Chicago's Continental Illinois National Bank & Trust Co., comments: "The resillience of the economy despite extremely high interest rates has puzzled many observers. Normal cyclical experience indicates, however, that it would be unusual for economic activity to show a renewed decline so soon after a recession, such as was experienced in 1980."

So far, most of the economy's weakness has been concentrated in automobiles, despite many sales-incentive programs, and in construction, especially housing. Although few economists expect a boom in autos or housing in 1982, even fewer think that things will get worse in the two industries. Most of the rest of the economy, including defense and energy-related industries, has been going strong.

Although few analysis believe real GNP will grow in 1982 at the 4 percent rate envisioned by the administration, most do expect growth around 2.5 percent. That wouldn't be strong growth, but it would require continued heavy private borrowing and would put upward pressure on interest rates.

Of course, the Federal Reserve could spoil such forecasts if it precipitated a true credit crunch, tightening money so much that credit wouldn't be available to some borrowers at any price. Market analysts have blamed recent stock-market declines partly on fears that a credit crunch and a deep recession are looming.

BANK RESERVES UP

Most economists doubt, however, that the Fed would permit such a development. In the past two months, the central bank has allowed bank reserves to grow at an annual rate exceeding 11 percent after keeping them flat through the first half. When banks acquire more reserves, they can make more loans.

But the Fed isn't likely to let the expansion of reserves get out of hand. Statements by Chairman Paul Volcker and other Reserve Board members show that they believe substantially easier money would be seen by the markets as inflationary and thus would raise rather than lower interest rates. "What the Fed would like," one bank economist says, "would be a slow and steady decline in rates."

A Chase Manhattan Bank study says, "There is concern that anything more than a gradual rate decline could lead to considerably stronger money demand and a surge in total spending. These, in turn, could quickly induce another sharp upward thrust in interest rates that could again jolt the economy."

In one way, high interest rates are helping to keep the economy afloat: High rates earned by consumers on money-market funds and savings certificates are bolstering spendable income.

SURGE IN INTEREST INCOME

"The increasing conversion of low-yielding consumer deposits into high-yielding deposits is resulting in a significant surge in interest income," says Lacy Hunt, senior vice president of Philadelphia's Fidelity Bank. "In the second quarter, personal interest income rose at a 19.6 percent rate, after a 31.3 percent surge in the first quarter. Among the components of earned income, interest income rose more rapidly than any other component in the first half."

The Reagan tax cuts, of course, will also serve to pump up spendable income over the next three years. The declining inflation rate, moreover, is adding to consumers' real purchasing power.

Many consumers are expected to buy the all savers certificates approved this year by Congress. These certificates, to be issued by banks and thrift institutions beginning Oct. 1, offer up to $1,000 of tax-free interest to single individuals and up to $2,000 to married couples. The certificates, which will initially carry a 12.61 percent interest rate, will help banks and savings institutions by providing them with relatively low-cost funds, but few economists expect a quick reduction in mortgage interest rates.

"The thrifts are in no position to cut rates," says Mr. Hoskins of Pittsburg National. "These are one-year certificates and mortgages run for 20 years or more."

[From the Wall Street Journal, Sept. 16, 1981]

SOLD SHORT—MANY WALL STREETERS REGRET THEY HELPED REAGAN PASS TAX BILL—A CAPITAL-GAINS PROVISION, ADDED TO WIN THEIR AID, WAS ABRUPTLY LEFT OUT—ROLE OF A "BOLL WEEVIL" CITED

(By Tim Carrington)

Many Wall Streeters now think that in buying President Reagan's economic program, they bought a bill of goods.

Their disillusionment extends beyond the well-publicized revival of their suspicions that Vice President George Bush was right when, campaigning in the Republican primaries, he labled the Reaganite program "voodoo economics." They also are annoyed because, apparently for nothing, they swallowed their earlier doubts and worked hard to help push the administration's tax-cut bill through Congress.

They did so because they were promised a plum: The holding period for an investment to qualify for favorable tax treatment as a long-term capital gain would be halved to six months. This long-sought tax break, Wall Streeters hoped, would spur investors to trade securities more often and thus would sharply increase brokerage firms' commission revenues.

But the securities industry's plum was knocked off the tax writers' gift list at the last moment, and many Wall Streeters who had campaigned for the overall bill feel betrayed. Along with their disappointment, their doubts about the chances of avoiding a resurgence of inflation have revived. They note that even President Reagan's own budget men, conceding that their initial deficit projections may have been overly optimistic, are seeking additional cuts in federal spending. "The emperor's clothes begin disappearing," comments Peter Solomon, a managing director at Lehman Brothers Kuhn Loeb Inc.

GLOOM ON THE STREET

The disappointment and the doubts have deepened the gloom on Wall Street and have helped depress the bond and stock markets. Since Congress passed the tax bill, the Dow Jones industrial average has plunged more than 80 points, and bond prices have hit record lows. Yesterday, the industrial average rebounded 8.56 to 862.44 in what was called a technical rally, and the bond markets also strengthened a bit.

Understandably, morale in the financial quarter also has deteriorated. George Ball, the president of E.F. Hutton Group Inc., says absenteeism has hit worrisome levels. He adds that he recently "walked into the (Hutton) bond room, and people looked like pictures of groups in concentration camps."

In Washington too, people are apprehensive: Members of Congress are getting especially rattled by constituents' complaints about steep interest rates. Majority Leader Howard Baker said in an interview this week that on the floor of the Senate "people are talking about credit controls, reorganizing the Federal Reserve, a windfall-profits tax on interest income, and wage and price controls."

FRAYED TIES

So great is the bitterness, both over the unanticipated continuation of high interest rates and over the collapse of the political bargain involving the capital-gains rules, that some observers expect ties between Wall Street and Washington to be frayed for months to come.

The whole situation is especially surprising because few people would have expected Wall Street to campaign vigorously on behalf of the Reaganite tax plan in the first place. Wall Street economists have generally favored reductions in federal spending along with selective tax cuts tailored to encourage savings and investment. They feared that the Reagan program, combining across-the-board tax cuts for individuals with tight monetary policy and higher defense spending, would keep budget deficits deep, inflation dangerous and interest rates high.

On Friday, July 31, however, Wall Street set aside its doubts about administration forecasts of balanced budgets, lower inflation and strong economic growth. That morning, five days before the House passed the Reagan tax bill, lobbyists for the Securities Industry Association were called to the White House for a special meeting. At that time, supporters of the President's plan felt that the trade group had given the bill only halfhearted endorsement. Moreover, House Democrats were scrambling behind Dan Rostenkowski, the chairman of the Ways and Means Committee, to support an alternative tax bill.

Although White House and Treasury officials attended the meeting, the discussion was led by Rep. Kent Hance, a Texas Democrat who had helped engineer the bargain to be proposed to the brokers: In return for political support, the capital-gains holding period would be changed back to the six months that had been required prior to 1976.

The offer of White House backing for that change came as an exhilarating surprise to the securities industry. And for the first time, the financial community actively supported the Reagan tax plan. "When they threw this giant plum at us—something so peculiarly and particularly tied to people investing—we really turned out all the troops," says Steven Seiden, a partner at Herzfeld & Stern and member of the Securities Industry Association's tax committee. Some people jokingly dubbed the new proposal the "all brokers" bill—in imitation of the "all savers" certificates designed to rescue ailing thrift institutions.

Within hours of the White House meeting, the SIA cranked up a full-throttle lobbying drive to push the Reagan bill through the House. With securities firms operating branch offices in every state, the industry commands a powerful lobbying machine.

The SIA set up "phone squads" to uncork a flood of calls to Capitol Hill, particularly to undecided members of Congress from their own districts. National brokerage firms such as E. F. Hutton and Merrill Lynch & Co. wired all their branch managers to urge them to call their Congressmen and push for the Reagan bill. Meanwhile, an SIA computer spun out names of brokerage industry officials friendly with particular members of Congress. These officials where contacted and urged to phone the legislators.

Between the Friday meeting at the White House and the House passage of the bill the following Wednesday, the securities industry generated as many as 20,000 calls to members of Congress, says Stephen Small, the director of congressional relations for the SIA. Others involved in the campaign estimate that the five-day total run as high as 35,000 calls.

Throughout the telephone blitz, the SIA kept a tally of Congressmen supporting the President or remaining uncommitted. On Friday, the trade group had identified about 90 fence-sitters. By late Monday, the count was down to 30, and on Wednesday, to only about 18. Wednesday afternoon, the Reagan tax bill sailed through the House by a 238-to-195 vote.

Two days later, the tax legislation went to a House-Senate conference charged with reconciling the House bill and a version passed earlier by the Senate. Among the points of difference was the holding-period reduction, which wasn't contained in the Senate measure and had been added in the House only at the last minute.

So Wall Street's lobbying continued full tilt in an effort to persuade the Senate conferees to go along with the House on the holding period. Industry officials were optimistic, and top Treasury aides saw little problem in gaining Senate acceptance of the provision. As late as 9:30 p.m. that Firday, the industry's lobbyists say, they had assurances that the House-Senate panel would accept the change in the holding period.

But around midnight, Wall Street's plum was suddenly pulled away. Rep. Rostenkowski proposed that the Senate's stance on the issue be adopted—that the provision not be included in the tax bill—and, after hardly any discussion, the panel went along with his suggestion.

SIA lobbyists were stunned. So were SIA members when they got the news. Told of the turnabout, one industry officials is said to have asked, "Who in the White House took our virginity?" Complains another Wall Street executive active in the telephone blitz, "There was a broken promise." Asked what the White House did to defend the provision that it had held out to Wall Street, a third executive snarls, "Not a goddamned thing."

A more accurate answer, according to a source who attended the all-night conference session, would be "not much," John Chapoton, the assistant Treasury secretary for tax policy, was in the room and was asked about the holding-period provision. "He did defend it," the source says, "in terms of saying this was part of the administration bill and that they did support it." But, the source adds, neither Mr. Chapoton nor the Republicans on the panel expressed "vigorous opposition" to dropping the provision. Mr. Chapoton couldn't be reached for comment.

Congressional aides say the provision was less a casualty of a White House betrayal than of House politics. Rep. Hance, in addition to stirring up Wall Street's campaign for the Reagan tax bill, helped deliver to the President the crucial votes of Southern Democrats in the House. Rep. Hance's "boll weevil" role in fragmenting support for the Democratic tax bill was deeply resented by Rep. Rostenkowksi, Ways and Means Committee staffers say. Other observers think that Rep. Rostenkowski was anxious to reassert his control over the Ways and Means Committee.

Moreover, the holding-period provision apparently began to fall into difficulty before midnight Friday, despite the industry's optimism. Just before the House-Senate conferees convened Friday afternoon, the five Democrats from the eight-member House delegation met to discuss differences between the House and the Senate bills. When the holding-period provision came up, says a congressional aide at the briefing session, some of the Democrats expressed surprise that it was even in the bill.

"It wasn't part of the Ways and Means bill, nor was it raised as an issue in the markup of the committee bill," the aide says. "It had no prior consideration at all. There was no attention given to this on the floor of the House. People asked, 'Where did this come from?' "

NOT INVENTED HERE

This aide also notes the traditional skepticism among Ways and Means Committee members toward tax changes that haven't been aired in their committee. Moreover, all five of the Democrats had voted against the President's tax bill on the floor of the House.

And when Rep. Rostenkowski proposed that the House defer to the Senate on the holding period, there was little protest from the Senators on the panel; the Senate, after all, hadn't included the provision in its bill.

A Rostenkowski aide says that before any changes are made in the holding period, the Ways and Means chairman wants to hold hearings on the proposal. And anticipating such hearings in the months ahead, some Wall Street executives are again pushing for a reduction.

Although the holding-period proposal had galvanized Wall Streeters into campaigning for the Reagan tax bill, other factors had previously muffled their reservations. Merrill Lynch, the SIA's largest member, was an early supporter of the Reagan package. Citing "Merrill Lynch pressure," one industry official says the SIA soft-pedaled the findings of a tax study that it had commissioned from Data Resources Inc. Of seven tax proposals, the original Reagan plan for a 30 percent tax cut for individuals was ranked the lowest by the forecasting firm in terms of the amount of economic activity likely to be generated for each dollar of federal tax revenue lost.

"WE WERE MUTED"

The SIA presented these findings in writing to the Senate Finance Committee but avoided any public rift with the administration. "We were muted," an industry official says, speculating that Merrill Lynch was doing the bidding of its former chairman, Treasury Secretary Donald T. Regan.

A Merrill Lynch spokesman dismisses the charge. "Don hasn't been in this building since he left," the spokesman says. However, an economist at the brokerage firm says that "informally, he's kept in touch with us" and that largely as a result of these contacts "we were educated about what was really needed to change inflation." Through an aide, Mr. Regan says he has severed all ties with the firm and, the aide says, "has scrupulously done everything he can to avoid having any impact on Merrill Lynch or its policy since he has been Secretary of the Treasury."

Other Wall Street executives say they were restrained in their criticism of the Reagan program not out of any pressure so much as a general desire to be supportive of the administration. "They bought the alchemy bit," says Mr. Solomon at Lehman Brothers. "Everybody likes to believe, and people like Ronald Reagan, and they like the general trend. The only thing they don't like is that it doesn't add up."

OTHER BOONS

Apart from the holding-period proposal, the Reagan program contained other provisions favored by Wall Street. For example, the maximum tax rate on individuals' investment income was cut to 50 percent from 70 percent, and that reduction, in turn, automatically trimmed the highest rate on long-term capital gains to 20 percent from 28 percent. In addition, liberalized tax breaks for leasing arrangements and for individual retirement accounts provided securities firms with new opportunities to market financial services. And Wall Street had long sought the cuts in corporate taxes and government spending.

However, many of these provisions were also contained in Rep. Rostenkowski's competing tax bill, which didn't include the radical tax cut that financial markets view as inflationary. In fact, one leader in Wall Street's lobbying drive for the

Reagan plan calls the Rostenkowski bill "intellectually a lot more pleasing to us." (That bill would have given individuals a 15 percent tax cut over two years, with another 10 percent reduction in the third year if the economy performed as the administration predicted; the Reagan plan chopped individuals' rates 25 percent over 33 months, a minor compromise with skeptics worried about the initial proposal for a 30 percent cut over three years.) However, the Wall Street leader says loyalty to the Reagan White House made support of the Rostenkowski bill all but impossible.

But the recently dismal financial markets suggest that Wall Street helped to impose a program in which it has little confidence. Despite occasional statements of support from financial leaders, many think that the markets remain the true barometer of sentiment."The Street speaks only on the tape," Peter G. Peterson, the Lehman Brothers chairman, said in a June speech. And because the main parts of the Reagan program—with the brokers' help—are solidly in place, Lehman's Mr. Solomon adds, "I don't know how we get out of this."

Senator WEICKER. As our first witness, we have the Honorable Jerry Jordan, member of the President's Council of Economic Advisers.

Mr. Jordan, it is a pleasure to have you before the committee. Please feel free to make your presentation in any way with which you are most comfortable. Your statement in its entirety will be included in the record following your presentation.

STATEMENT OF HON. JERRY L. JORDAN, MEMBER, COUNCIL OF ECONOMIC ADVISERS, WASHINGTON, D.C.

Mr. JORDAN. Thank you very much, Mr. Chairman and members of the committee.

Let me say first that this is one economist who does not like high interest rates. I want low interest rates. I believe you would find that most economists actually want low interest rates, especially in nominal terms, but it is a question of methods of how we achieve low interest rates. We believe that the policies of the administration and of the Federal Reserve are designed to achieve lasting low interest rates, not temporarily and artificially low-interest rates.

I believe that the problem affecting Wall Street is not tight money and it is not simply concern over the deficit, but it is fear of easy money. Wall Street's concerns are mostly that the anti-inflationary monetary policies will not be maintained.

Even if they believe 90 to 95 percent certain that the policies will work as we say that they will and that the Federal Reserve will stay on an anti-inflationary monetary policy, that 5 or 10 percent of uncertainty that it may go the other way is too much for them. They want 100-percent certainty. The risks are asymetrical to them, and to run even a small probability of another round of highly inflationary monetary policy is something they are not willing to gamble against.

I appreciate having the opportunity to talk on the problems of interest rates and credit requirements as they affect small businesses. This is an area that the administration has considerable interest in. We recognize the importance of small business to the vitality of the economy, and we also recognize the dependence of small business on external financing.

We are aware that small business has carried most of the load in job creation in the past, and we are counting on small business in the future to be where new jobs are created and to provide the kind of employment that we are counting on to result from our programs.

There are several points I want to cover to convey to you how we see these problems.

We agree that high-interest rates are a serious problem, but we do think that it is a temporary problem. We do not agree with the people who forecast interest rates rising from present levels.

The administration will continue to show its determination to reduce Federal spending and Federal credit demands. As it does so, interest rates will come down, and, as the President's broader program takes effect, rates will stay down.

However, it is important that interest rates come down as a result of market forces pulling them down and not because of their being pushed down either by the Federal Reserve or by the artificial effects of credit controls.

Inflation has been a longstanding and a chronic problem much more harmful to small business than are the current high interest rates. The President's program is aimed at reducing inflation not just over the cycle but a permanent decline in inflation and therefore a permanent decline in interest rates. That can be achieved only by reducing money growth.

For this reason, we feel that in the end small business will gain considerably by the monetary portion of the program. There are short-run adverse effects of high interest rates, but they cannot be relieved by faster monetary growth.

The transitional effects of the monetary component of the President's program is creating problems, but there is much in the program that has been enacted so far that provides immediate benefits to small businesses. In particular, the recently enacted tax package and the agenda for regulatory review and reform provide billions of dollars of capital to small business. This is a long-term improvement in the business climate that starts now.

There are longer term problems of small business financing that do require further study. With the introduction of wider competition in financial markets, credit that once was rationed at the discretion of individual banks according at times to nonprice criteria may now be more sensitive to interest rates. This may cause small businss to pay high market sensitive prices for credit during periods of credit restraint.

As directed in title V of last year's amendments to the Small Business Act, the Comptroller of the Currency, the FDIC, and the Federal Reserve are currently undertaking a complete review of this matter. Their report is expected to be completed early next year. The administration will give prompt attention to their finding.

Finally, it would be a grave mistake to opt for credit controls either as a solution to the short-term problem or as a cure for the longer term problem of financing small businesses. It would be counterproductive.

The interest rates we have today are high by historic standards. Frankly, although there is a good deal of anecdotal evidence that the adverse effects of these rates on small business are disproportional, we have no good statistics to back up these assertions, and no economic analysis to say exactly what happens and why. I will come back to this problem of our lack of data.

Right now, some of the best comprehensive evidence we do have on the current state of the small business sector is contained in the quarterly survey of the National Federation of Independent Business. In the quarterly survey for July, interest rates and financing became the single most important problem facing small business according to that survey.

High interest rates were cited by 21 percent of the respondents as their single most important problem in the second quarter of this year. In the past, financing problems have been cited as the number one problem by only about 10 percent of the respondents.

This is the first time in the 7-year history of that survey that "interest rate-financing" has been cited by a plurality of firms as the single most important problem facing small business, according to the authors of the study, Professors Dunkelberg at Purdue and Jonathan Scott at Southern Methodist.

That leaves us with the question of why interest rates are so high. For 20 years, successive administrations and monetary authorities have alternated between the fight against inflation and temporary measures to shore up employment. Although such measures have had no permanent effect on unemployment—in fact, my view is that the efforts in the short run at times to reduce unemployment to monetary stimulus has raised long-term unemployment—they have given us a legacy of continuing inflation and, most important, expectations of continued high inflation.

Every program to fight inflation is justifiably regarded with skepticism. It will take a continued application of an effective anti-inflation program to relieve that skepticism.

It is widely known and accepted among economists that the root cause of long-term inflation is excessive growth of money and credit. There is no way to make permanent headway against inflation except by reducing money growth. We are firm and resolved in our support of the Federal Reserve's actions to achieve that end.

What is being inflated, ultimately, is the quantity of money. We measure inflation by looking at various price measures, statistics on prices, but that is not what is going on. It is an erosion of the purchasing power of the medium of exchange, the Nation's currency, that is the problem. The only way you can deal with that problem is to control the quantity of money that is being created.

We are determined to relieve the long-term pressure on the monetary system of supporting a swollen Federal budget. Attention has been focused recently on projections of the deficit that seem to suggest that we may falter in our determination to achieve a balanced budget by 1984.

I want to caution everyone to remember that deficit projections are always changing. Each represents only a way station, and often only an imaginary way station, on the road to fiscal prudence. We are maintaining constant pressure throughout the Government to bring down spending. We will continue to do so.

In this light, it is interesting to note that as much as anything it is the skepticism of investors that is pushing to destroy that one goal that they most wish the President to achieve since much of the external pressure on spending is coming from interest rates.

A number of analysts have recently pointed to the President's program of tax cuts as somehow being excessive. That simply is not true. At the same time as we reduce inflation, we must restore the potential for real economic growth that has been stifled by an excessive tax burden in an inflationary environment.

We just cannot wait until we have cured inflation to begin restoring the economy's strength. In that vein, the reduction of tax revenues provides the greatest possible incentive for reducing Government spending.

The effect of the tax program as it has been enacted by Congress is to simply put a ceiling on Federal tax revenue at 20 percent of national income. The elimination of the deficit now requires bringing Government spending down from about 23 percent of national income this year to about 20 percent of national income, about 3 percentage points of GNP by 1984.

However attractive the benefits, some will argue that the price, temporarily high interest rates, is too great to pay, that interest rates themselves will choke off the growth that we so badly need, especially in the small business sector.

Inflation, I should remind you, is the No. 1 long-term problem directly, and also underlying the problem of high-interest rates. Citing again that small business survey, until July of this year, inflation has been cited by more firms as the No. 1 problem than any other difficulty. Even when interest rates are the worst problem, being cited as such by 31 percent of the firms, inflation was still cited as the worst problem by 26 percent of the respondents. Thus, while high interest rates capture the headlines, inflation remains the continuing danger. Our program is aimed at this longer term problem.

We should not focus only on the transitory pain of high-interest rates in judging the President's program and its effects on small business. I confess that it is all too human to take the good for granted and to complain about the unpleasant, so I think it is essential to look at the other features of the program and their impact on small business. It is hardly a bed of thorns.

In particular, a number of features of the tax package provides significant benefits to small business. Furthermore, the task force on regulatory relief, headed personally by the Vice President, will be reviewing many of the onerous regulations faced by small business.

First, let me comment about the tax act. The tax reduction for small business alone is on the order of $2.5 billion for fiscal 1982 and $8.5 by fiscal 1986. A full explanation of the bill's attributes in this area is within the responsibility of the Treasury. I have appended it to my testimony.

It should be clear that all of the long-run effects of the program, spending reduction, regulatory relief, tax reduction, and inflation reduction will be salutory for small business. We think on net small business will benefit even in the short run.

Appropriate for today's discussion, Congress has mandated a full review of the credit needs of small business. That study is being carried out by the comptroller of the currency, the Federal Reserve Board, and the FDIC, with the advice of the SBA and the Census Bureau. I am told that this study will be delivered to the Congress on February 1.

The results of this study are going to be particularly interesting to those of us in the administration. In a recent press release, the authors of the study noted that credit is widely available, even to small business, although at a high price. There is no hard data, but it seems to me that this is a very different situation from what was the case even a few years ago when tighter credit conditions often meant that credit was not expensive, but it was also not available. I hope that you can learn from this credit needs study as we hope to.

We believe that the imposition of credit controls, if that were an action that were seriously considered, might have the temporary effect of lowering the price of credit, but would make credit totally unavailable at all to many small businesses as well as to consumers.

We think that no policy could be more ill advised than consideration of administrative approaches to dealing with credit availability and credit allocation. The only way to make credit more available is to increase savings or to return to the fast and loose policies of money and credit creation that brought on inflation.

Since the end of World War II, our Federal Government has had a very difficult time managing its own financing. I see no evidence that we can manage the private sector's finances any better. If there were need for immediate proof of this assertion, I need only remind you of what happened in the second quarter of 1980 when credit controls were last attempted.

Thank you, Mr. Chairman.

Senator WEICKER. Thank you very much.

I will try to keep my questioning brief. I know that various members have many matters they would like to discuss.

To get down to the nitty-gritty of all of this, what concerns me is that small businesses are just going belly up at an unprecedented rate. Yet, as you state, they have been the main impetus for employment and innovation in this country.

How much are we willing to reduce the ranks of small business? Granted that while there may not be an immediate effect as to our economy, certainly that type of situation taking place will have a long range effect.

At the same time that small businesses are going bankrupt because of the high interest rates, the administration policies vis-a-vis competition and mergers are rather loose and liberal in the sense of looking the other way. Therefore, more small businesses that cannot afford high interest rates get soaked up in that fashion.

I think this may be a great monetary policy for big companies and rich people. Beyond that, I want to know who is going to be left standing.

Mr. JORDAN. The extension of credit involves merely a transfer of purchasing power from one party to another. The price of credit rises with inflation along with everything else. When credit is employed in a merger, such as the very large mergers we saw this summer, there is a temporary effect on the credit markets, especially coming through financial institutions, the large commercial banks, but it has no lasting effect on availability of credit or price of credit to small businesses or to consumers.

When one corporation borrows funds, whether on the domestic market or the international market, in order to make an acquisition, the recipients of those proceeds then have to do something with it. It is a hot potato. The money does not disappear out of the system. Only the Federal Reserve——

Senator **Weicker**. However, the businesses are disappearing.

Mr. **Jordan**. Not because of credit being used up by large mergers.

Senator **Weicker**. Mr. Jordan, the problem of small business is one of two things. Small businesses do not have the capital to begin with that large business has; No. 2, small business cannot afford to borrow at 20, 21, 22 percent. They are driven into a situation where either they go bankrupt, as I indicated, or they have to ally themselves with somebody who does have the capital or the resources to go into the markets at the present interest rates.

I do not care what happens to the money. I am not discussing that right now. I am discussing the businesses. They are gone.

Mr. **Jordan**. We agree that the price of credit is a serious problem for small businesses as well as it is for consumers and home buyers. We want the price of credit to come down. We would like it to come down just as rapidly as the market will allow it to come down. We believe the market will allow it to come down only as the result of inflation and inflation expectations coming down.

We have made progress on inflation this year, I believe, thanks in part to a reduction in Government spending and to monetary restraint, but also in part because oil prices in real terms are now declining, we have had very good crops and food prices did not rise as much as had been expected this year, and wage increases have been less.

We have been seeing some favorable developments on inflation but not on inflation expectations. When you talk to people in the bond markets, on Wall Street, they think this is a temporary cyclical decline in inflation, that it will take off again.

They have seen several periods starting in the early 1960's where each time, 1966, 1969, 1974, and 1980-81, we ratchet to higher and higher inflation levels and interest rate levels. Each time the peak levels of interest rates have been 50 percent above the prior peak. When interest rates and inflation come down, they do not come down as far as they were before, and then they start up again.

The market participants today expect that we will have a short-term, near-term decline in interest rates inflation, that this administration, the Congress, and the Federal Reserve will do what has always been done before in such periods, that they will ease up prematurely, artificially start to restimulate before the problems of inflation are unwound, and they are projecting ahead the level of inflation interest rates in the next 2 to 3 years will be 30 percent.

We are determined to prove them wrong, but if I were back in the private sector right now, that is the way I would bet, that inflation and interest rates will be 25 to 30 percent in the next 2 to 3 years because of the lack of determination to deal with inflation in a long-term way.

Senator **Weicker**. I cannot see penalizing the weakest elements of our society in terms of whatever remedy is being devised by the administration.

As I have indicated to you, bankruptcies are running 50 percent above last year. I go back to my home State of Connecticut and, believe me, whether they are homebuilders, real estate people, or one of the hundreds of small businesses, they are getting killed. I do not see Du Pont getting killed. I do not see Exxon getting killed. I do not see any of these big corporations getting killed out there at all.

I come back to the points raised by Senator Tsongas. I think they are willing to hitch in their belt and do things that are a little bit on the unusual side, but I tell you what I do not think they are willing to do: No. 1, I did not find anybody out there screaming and yelling for an enormous personal tax cut. That was plain old-fashioned politics to make the rest of it palatable.

No. 2, defense spending is Government spending. I think that you as an economist will admit that it is the most inflationary spending of all. There is no consumer in the process. It is by far and away the most inflationary, and it is without any regard or justification in terms of specifics.

We can sit here and talk about economic theories, Wall Street's worries, and all the rest of it. I am not worried about Wall Street. No. 1, they can do whatever they want to do. They are wrong more often than they are right, but that does not bother me.

However, I am very much concerned about the flesh and blood out there that is really being made to suffer. I just do not think it is across the board at all. It is a very unequal suffering that is taking place in this Nation.

Mr. **JORDAN**. We agree with that. It is small business. It is homebuilders. It is potential home buyers. It is real estate brokers. It is farmers. They are not going to be helped by credit controls though. Credit controls do not——

Senator **WEICKER**. I am not arguing for credit controls.

Mr. **JORDAN**. Credit control does not affect the large companies. In the mergers this summer, we saw that more than half of the credit employed for those mergers was borrowed internationally, partly because of lending limit problems of the major banks. It was borrowed on the Eurodollar market.

We have to find ways to make credit available at lower prices for small borrowers. I do not know any other way to do that than to get the inflation premium out of interest rates. If that inflation premium comes out, the faster it comes out, the more credit will be available at a lower price. I do not know any other way to do it.

Senator **WEICKER**. Senator Nunn?

Senator **NUNN**. A minute ago, Mr. Jordan, you mentioned that the inflation rate is coming down at this time; correct?

Mr. **JORDAN**. Yes, sir.

Senator **NUNN**. However, you are saying inflationary expectations have not come down?

Mr. **JORDAN**. That is right in the long-term markets.

Senator **NUNN**. That the long-term markets are still expecting that the Federal Reserve, Congress, and administration will react in an historical pattern, that is to say to stimulate the economy with fiscal policy when things get tough?

Mr. **JORDAN**. And monetary policy.

Senator **Nunn**. Do you consider the present fiscal policy stimulative, or do you consider it neutral at the present time?

Mr. **Jordan**. That is a useful question.

Senator **Nunn**. Let us just say for right now. If the policies that exist on the books stay as they are, if no laws are changed, if the tax cuts stay as they are, how would you describe fiscal policy?

Mr. **Jordan**. Let me first comment that the traditional analysis would say that any tax rate reduction has a stimulative effect. Increasing disposable income to individuals causes more spending.

Senator **Nunn**. Right.

Mr. **Jordan**. The kind of tax reductions that we have so far do not do that in a major way. The 5 percent tax reduction beginning October 1 does not even roll back the effects of inflation on the bracket creep, the ratchet this year, and the social security increase. Real taxes have risen in 1981 as compared to the year before, and in 1982.

Senator **Nunn**. However, you cannot just consider tax cuts without also considering Federal spending when you discuss fiscal stimulus. That is where the administration's argument begins to have problems.

You have more problems when you continue to have 50 percent of Government programs indexed and Government spending continues to go up. The net fiscal policy of what I am talking about is not just taxes but also expenditures.

Mr. **Jordan**. That is right. You have to take the two parts together. Even in 1982, real taxation will rise for most of the year. Therefore, in a traditional analysis on real tax burden, fiscal drag, you cannot look a the tax side and say it is stimulative even in that analysis until the second half of next year.

What it does is put a cap on——

Senator **Nunn**. It becomes stimulative in the second half of next year?

Mr. **Jordan**. Only to a small degree in that it does at that time reduce tax revenue as a share of national income, but that is in the second half of 1982. At the same time, the traditional analysis would say that cutting Government spending as a share of GNP, which is already going on in 1981, would be a restrictive action.

The standard analysis says cutting Government spending is restrictive policy. It is coming down this year. It will go down more next year and the year after.

Senator **Nunn**. That is based on a large number of unspecified cuts.

Mr. **Jordan**. Even without the further unspecified cuts. On the first resolution last spring, it will still come down. We do view that analysis as stimulative to the investment sector in the sense that it is a resource transfer out of the Government sector into the private sector.

If you look at what it would be through 1984 with the further unspecified cuts, it is about 3 percentage points or 3.5 percentage points of gross national product. At that time, gross national product is going to be about $4 trillion. Therefore, we are talking about $150 billion that will not be in the Government sector as a share of national income and that will be in the private sector. That is viewed as a stimulative action to capital formation, to saving, to investing in the real terms.

Yet, the fiscal policy we do view as being stimulative to investment. We do not view it as stimulative to consumption. That is a point of some contention among some economists.

On the other hand, we do view monetary policy, in the sense of being measured by the growth rate of the money supply, as being an anti-inflationary policy. We think that the two reinforce each other. We do not see them as in conflict.

Senator NUNN. Whether it is stimulative to investment or consumption, still whether you invest or you consume, you still increase borrowing, do you not? Does not most investment involve borrowing?

Mr. JORDAN. If you increase saving, then by definition you have increased borrowing.

Senator NUNN. You are now throwing in another assumption.

Mr. JORDAN. No, that is a part of the basic assumption.

Senator NUNN. If you were working in the financial markets, and in order to project long-term inflation rates you had to assume, No. 1, that there was going to be an unprecedented rate of saving in the United States——

Mr. JORDAN. To support investment, yes.

Senator NUNN. No. 2, that there was going to be a huge, huge additional spending cut unprecedented in the history of our Nation that are not yet specified——

Mr. JORDAN. Part of it.

Senator NUNN. If you had to make those two assumptions for it to be a nonstimulative fiscal policy in the consumption arena, would you not be very skeptical?

Mr. JORDAN. The skepticism would come on the grounds of whether or not the deficits, while they still remain, will be tolerated by the Congress and the executive branch because of the implications for interest rates and the monetary authorities.

In a sense, you cannot pick and choose and say we are going to have deficits and therefore interest rates are going to stay high and investment is going to stay sluggish because the expectation is that we will not tolerate that and we will take some other action. Because we want more investment, we will try to do something to stimulate investment saving.

Senator NUNN. I think the key to the faith you are asking people to have is on page 5 of your statement. You says: "In that vein, the reduction of tax revenues provides the greatest possible incentive for reducing Government spending."

What you are saying is you have gotten the tax cuts way out in front of the spending cuts, but you hope the spending cuts will follow.

Mr. JORDAN. That is correct.

Senator NUNN. That is a very great leap of faith, is it not?

Mr. JORDAN. It is one that I think is most troubling to the bond market people.

Senator NUNN. If you were an investor, based on the history of the country and the fact that the President has excluded social security, largely excluded defense, veterans, and of course interest on debt, which represent approximately 75 percent of the budget from further cuts, and that in order to meet his budget cuts, he has to virtually eliminate all the other Government, would you not be skeptical?

You have to severely limit transportation, housing, revenue sharing, education, aid to the handicapped, and a good many others. What is the bond market to do? You would have to be foolish to believe that these things are going to be cut to the bone, would you not, particularly when you read in the headlines every day that the Republican leaders are rejecting almost every proposal the President makes on spending cuts?

Mr. **Jordan**. However, that is where the markets understand that ultimately this decision has to be made in Congress as to what these priorities are regarding entitlements and the 32 percent of the budget that is indexed.

Senator **Nunn**. Mr. Jordan, do you not think the markets would respond favorably if we were to take 1983 and 1984 individual tax cuts in some form, put some conditions precedent in front of them relating to spending cuts, and say that those tax cuts would take effect proportionate to the spending cuts that are made rather than automatically regardless of circumstances? What do you think the interest market would do if we were to do that?

Mr. **Jordan**. I think it would have two effects. I think it would probably have a positive effect on the financial markets and a negative effect on real capital formation and real investment. It would create an environment where we would essentially be on a plateau, a relatively stagnant period. We could possibly stimulate consumption, but we could not stimulate investment.

Senator **Nunn**. What good does it do to have capital formation if huge segments of your economy cannot afford the interest costs in order to borrow that capital?

Mr. **Jordan**. The interest costs will come down as people believe that inflation will not take off again. The inflation premium has to come down first.

Senator **Nunn**. Are you saying supply and demand in the money market is irrelevant, that it is simply inflationary expection that determines interest rates?

Mr. **Jordan**. No, supply and demand is dominantly influenced these days by inflationary expectation, both on the part of the consumer—buy now before the price goes up because you can deduct your interest expense from taxation, and you pay back with cheaper dollars so real borrowing costs are often still negative even for small businesse—and especially for large businesses.

We have increased through the tax legislation enacted so far real returns to savers. For the first time in our recent history individuals who are net savers are getting a positive after-tax, after-inflation return on their savings. Interest income is earned more by the older age brackets. This interest returned to them has gone up.

There is no way we can increase the real return to savers—we have long wanted to do that to give savers a fair shake on their savings—and to say that savers are going to have a higher real return without saying borrowers are going to incur a higher real cost.

Senator NUNN. Does the administration at this point unequivocally support the tight money policy of the Federal Reserve Board?

Mr. JORDAN. We unequivocally support an anti-inflationary monetary policy, and that is what we have.

Senator NUNN. The Reagan administration unequivocally supports the Federal Reserve Board's present policies.

Mr. JORDAN. Let me be quite clear that that does not mean that we view interest rates as either a target or a tool of monetary policy. We do not think that the present interest rates are something that is necessary to maintain an anti-inflationary policy.

Senator NUNN. Do you blame the Federal Reserve for the present interest rates?

Mr. JORDAN. No, I do not, not as far as actions in 1981. As far as previous actions of fiscal policy in the 1970's, and monetary policy, I do blame both the Government and the Federal Reserve.

Senator NUNN. At this point in time, during 1981, the Reagan administration unequivocally supports the actions of the Federal Reserve Board?

Mr. JORDAN. As far as creation of monetary growth, yes, sir.

Senator NUNN. Where do you disagree then? I am just asking a question. If you disagree with anything the Federal Reserve has done in 1981, would you please enumerate it?

Mr. JORDAN. I do not disagree with anything the Federal Reserve has done.

Senator NUNN. I am asking about the Reagan administration now. Are you speaking personally or for the Reagan administration?

Mr. JORDAN. Both, in this case as far as any actions of the Federal Reserve, but we do not want that to be interpreted that we think the level of interest rates is a target or a tool of policy. It is not. It is a result of the history of inflationary expectations and inflationary experiences.

Senator NUNN. You do not like the results of what they have done in terms of interest rates, but you do agree with the action?

Mr. JORDAN. Yes, we do, but we do not want them to take actions to do anything about the interest rates either if that would mean that it would kick off another round of inflation.

Senator NUNN. What you are saying is you do unequivocally endorse the Federal Reserve's actions in 1981?

Mr. JORDAN. Yes, sir.

Senator NUNN. Why has the administration missed the mark so badly on the interest rate forecast?

Mr. JORDAN. Oh, I think in part we did not realize how severely damaged the inflation psychology was. We thought that maybe people in financial markets, savers, borrowers, would restore their confidence in a long-run inflationary policy more quickly than they have.

Such things as the oil glut have contributed temporarily to high short-term interest rates. We have tankers floating all over the world full of the stuff at roughly $50 million per tanker to finance it. That has to flow through the banking system. It just does not show up in normal inventory figures.

Senator **Nunn**. On the other hand, the oil glut has driven down the price of oil. That has had something to do with the inflationary relief we have had.

Mr. **Jordan**. However, the short-run effect of that has been that you have to finance this inventory of oil. It is the same phenomenon as the end of any business cycle. When you build up inventory, that has to be supported by credit, and credit is the transfer of purchasing power. It has to come from someplace.

The very strong dollar this year has resulted in part because investors throughout the world have more confidence investing in real long-life productive assets in the United States. Real rates of return have gone up, so the dollar has been very strong. Americans are repatriating investments from abroad. Foreigners are investing in the United States.

However, that has meant that foreign central banks have been selling back to us the debt that they acquired over the last 3 or 4 years when the dollar was very weak.

Senator **Nunn**. Mr. Chairman, I will be through after this line of questioning.

The administration projects in 1982 a 5.2-percent real growth rate. Is that right?

Mr. **Jordan**. That was the mid-year forecast, yes, sir.

Senator **Nunn**. Is that real growth rate above the rate of inflation?

Mr. **Jordan**. That is net of the rate of inflation.

Senator **Nunn**. What is the latest inflation projection by the administration?

Mr. **Jordan**. On a fourth-quarter basis, I believe on the deflater it was 7.3 percent.

Senator **Nunn**. If you add 7.3 and 5.2, the administration is then projecting at 12.5 nominal growth rate. Is that right?

Mr. **Jordan**. That was from the fourth quarter of this year to the fourth quarter of next year, yes, sir.

Senator **Nunn**. Is that still the estimate?

Mr. **Jordan**. Yes, sir, it is the only estimate we have. We are of course working on those.

Senator **Nunn**. What rate of growth in the money supply does the administration project that the Federal Reserve will allow?

Mr. **Jordan**. We take that as given. They have announced their targets for next year, a range for the broad measure of money, M_2, of 6 to percent, and the narrow M_{1B} measure of 2.5 to 5.5 percent.

Senator **Nunn**. You are monetarists, right? You believe in the monetary theory and so forth?

Mr. **Jordan**. Yes, sir.

Senator **Nunn**. How do you get a net 5.2 or a gross 12.5 growth rate in the economy out of a 2.5- to 5.5-percent growth in the money supply?

Mr. **Jordan**. We are working on that.

Senator **Nunn**. That is the best answer of the day.

Mr. **Jordan**. For the 1st year of an expansion, the 1st 4 quarters of a recovery period, we have had quite high rates of velocity growth, the rate of turnover of money. They would be in the 1957–

58 cycle, 1960-61, and 1974-75. As we began the first part of the recovery, we had very high rates of growth of velocity.

The 1974-75 case was a very interesting one where most of us felt that nominal income growth, real growth, in 1975-76, coming out of the recession, would not be very high, whereas Arthur Burns, chairman of the Federal Reserve at that time, said, no, you are forgetting that in the initial phase of an expansion velocity picks up very rapidly.

Senator NUNN. For how long? How many months?

Mr. JORDAN. About four quarters, about 1 year.

Senator NUNN. You are sitting here and telling us you really do expect to be able to have a 2.5- to 5.5-percent growth in the money supply and a 12.5-nominal growth rate and 5.2 real growth rate in the economy? Do you really believe that projection? I am not asking administration policy now. In your own individual view, do you really believe that projection?

Mr. JORDAN. I think that that projection has to be reconsidered.

Senator NUNN. You think it has to be reconsidered. You think it is unrealistic?

Mr. JORDAN. A lot of the factors, the basic assumptions having to do with energy prices, agricultural prices, the strength of the dollar—which means export demand is going to be less next year, and that will hurt GNP; import demand being stronger because of the strength of the dollar—a negative effect on GNP—the high interest rates that have prevailed much longer than we thought they were going to, that went into producing those numbers last year—it was really produced last February—were not part of the assumptions last February, and we have to fold those all in now.

We have to look at something like the all-savers certificate which comes into being on October 1 and what that will do to credit flows in the housing markets.

Senator NUNN. What do you think would be a reasonable net growth rate assumption for us to proceed on now? What is your personal view on that? I am not asking you to speak for the administration on this. I know they do not have an adjustment.

Mr. JORDAN. I honestly do not have a number in mind on the breakdown on real because we are trying to decide what assumptions to make about energy prices next year. Earlier, we had energy prices rising in real terms after inflation next year. I think they should come down If inflation would come down more, we have more room for real growth.

Senator NUNN. My time has expired. In fact, I am going overtime, but I would like to know, hypothetically, if the growth rate were to come 2 points—let us say that instead of 5.2 it would come down to 3.2—what would that do to the deficit? Do you know what it would do to the Federal revenue projections?

Mr. JORDAN. Not offhand.

Senator NUNN. I mean a ballpark figure. I have no idea. Are you talking about another $40 billion or are you talking about $20 or $100 billion in less revenue?

Mr. JORDAN. Oh, no; it would be much smaller than that. With 2 percentage points less on nominal income growth next year, you have to net as to what you would have on revenue shortfall versus maybe less interest expense, because interest rates would also come down more and you would have less credit demand and less inflation. Therefore, you would have less interest expense. The net of that would be well under $10 billion, but I do not know precisely what it would be.

Senator Nunn. Per point, or for 2 points?

Mr. Jordan. No, for the 2 points. Energy prices declining means, for instance, that the energy consumption outlays are going to be less for the military. We had $1.7 billion shortfall on military outlays just in the second quarter of this year alone because of energy prices declining.

Senator Nunn. Is the administration in the process of revising that real growth projection?

Mr. Jordan. We are doing a thorough, from the ground up, look at the inflation assumptions, the forecast for inflation, real output, housing, autos, everything.

Senator Nunn. When can we expect a revision of that?

Mr. Jordan. That will not be considered final until December.

Senator Nunn. How are we supposed to cut the budget another $13 billion not even knowing that if we do that it is going to really have the desired effect? How are we supposed to operate in the next 2 or 3 months when the adminsitration's projections are obviously completely out of whack.

Mr. Jordan. I would not say they are completely out of whack. It is a question of whether the further reductions are being considered as a result of projections of outlay overruns versus revenue shortfall. I do not view them as being exactly the same as far as a source of concern and something to be dealt with in the short run.

Because of higher interest expense this year and the assumption for interest rates for next year—the midyear review had to be raised by, I think, 2 percentage points—interest expense projected for next year for the fiscal year beginning in October is quite a bit higher than what we assumed earlier. Either you have to accept higher outlays or cut someplace else to offset that.

Senator Nunn. Thank you.

Mr. Chairman, I know I have gone overtime. I will make it up on future witnesses. I will not take that much time.

Senator Weicker. Senator D'Amato?

Senator D'Amato. Yesterday, Mr. Jordan, the Federal Reserve sold securities. Were you aware of that?

Mr. Jordan. No; I was not.

Senator D'Amato. Apparently they sold quite a bit. When they sell securities, what takes place? Do they take credit out of the market?

Mr. Jordan. There are several things. First, it depends on whether they are selling for their own account or for customer account. I do not know what the case was.

It depends on whether they were taking what is called a defensive action offsetting the effects——

Senator D'Amato. They sold for their own account. When you sell for your own account, do you or do you not take credit out of the market?

Mr. Jordan. Only if it is not a case where there are other factors of supply and reserve. Suppose a Federal Reserve float was going up, credit supply to float or credit supply to the discount window because of increased borrowing. A number of factors do supply credit to the market reserves that the Federal Reserve does not control. Often in their portfolio they will take actions to offset those effects, to simply neutralize it and come up with the same net figure. I do not know what the case was yesterday.

Senator D'AMATO. Let me tell you what the effect was: It drove down the bond market. They sold and they drove down the bond market. What is the effect on the interest rate going to be?

Mr. JORDAN. If they drove prices down, yields would be up. I doubt that——

Senator D'AMATO. Is that not what is taking place rather consistently?

Mr. JORDAN. No; interest rates have been declining for the last 5 or 6 weeks. The Federal funds rate has come down fairly fast week after week. The weekly averages have been declining, and they have been declining at a time when the money supply has been below target and reserves have been growing very slowly.

We have had the interesting situation all of this year where money grows fast, interest rates rise. When the money supply grows slow, interest rates decline. In a certain sense, if you wanted interest rates to come down really fast, the best thing that could happen would be for the Federal Reserve to sharply shrink the money supply. I would not advocate that, but as a solution to the interest rate problem, it would probably work.

Senator D'AMATO. If we do not begin to get that interest rate down, which has to a certain extent been manipulated by the Federal Reserve because, it appears to me, they disagree with the administration's policies——

Mr. JORDAN. Oh, I do not think the Federal Reserve disagrees with the administration's policies.

Senator D'AMATO. What is Mr. Volcker saying?

Mr. JORDAN. That he is determined to bring down inflation. The only way to do that is to bring monetary growth and sustain it over time.

Senator D'AMATO. You mean the deficit has nothing to do with it?

Mr. JORDAN. The deficit has a lot to do with the ability to sustain an anti-inflationary monetary policy over time.

Senator D'AMATO. Then obviously he disagrees with the fact and feels that more has to be done from one side if it is not being done from the other side, meaning the deficit. Is that not correct?

Mr. JORDAN. That is correct. In order to sustain the monetary policy, the fiscal must be compatible.

Senator D'AMATO. First, we will get inflation down. Then maybe we will have interest rates come down, but there will be no one there left in the small business community.

What you call artificial stimulation will not do the dead business community any good because they are going to be finished. I just think we are making exercises in monetary policy and economy philosophies while we have people who are literally going out of business and whose businesses are dying.

I think Senator Nunn's point is well taken. You are then going to find there is a great revenue shortfall based upon the fact that the tax base is not going to be there. You are not going to have a lot of people paying income taxes and you are going to have a lot of people on unemployment roles. I wonder if you factor that into how much more we are going to be spending.

Mr. JORDAN. Yes; we do. Every week this year when the money supply has jumped up on Friday night at 4:10 p.m. when the Federal Reserve announces what the money supply did, interest rates also went up. In the weeks when the money supply declined, interest rates came down. We have this paradox that anything that was attempted to provide more reserves or credit to push interest rates down would be counterproductive.

Senator D'AMATO. They start and stop selling every once in awhile for their own credit and create this kind of impression. It has been a pattern they have engaged in for a number of years.

Speak to the experts on the bond market. They will tell you how they can make money every time. They can predict exactly whether the bond market is going to go up or down when the Fed buys or sells securities. I am speaking about some mutual friends of ours who are very sophisiticated in this area. They know it and they are making money. We are being very severely damaged by this.

If you just continue it, I think we are going to have economic stagnation not only for the small business community but the large industries as well. Reaganomics is in deep trouble as a result of this flimflam.

Mr. JORDAN. One of the reasons I started to point out the interest rates this year has to do with the strength of the dollar. In one sense, we look and we say a strong dollar is a good thing because it represents confidence in our economic programs from abroad.

However, at the same time we recognize the strength of the dollar does reduce export competitiveness and future export demand. Also, it has caused major foreign central banks around the world to sell massive amounts of U.S. Government debt into our markets, pushing down prices, temporarily pushing up interest rates in the short-term markets in order to support their own currencies.

We thought it was kind of great back in 1977, 1978, and during that period when the dollar was weak and foreign central banks were financing our deficits for us. Well, they are selling them back to us now. It is their central banks that are selling U.S. Government debt, not our central bank.

The foreigners who have been complaining about our high interest rates causing the dollar to be strong have, I think, the cause and effect reversed. The dollar has been easing recently, and interest rates have also been declining. We expect the pattern of interest rate decline to continue in a sustained way.

Senator D'AMATO. I hope you are right.

Mr. JORDAN. I do, too.

Senator D'AMATO. I have no further questions.

Senator WEICKER. Thank you very much, Senator D'Amato.

Senator Huddleston?

Senator HUDDLESTON. Thank you, Mr. Chairman.

I will just take a couple of minutes because Senator Tsongas and others were here before and I did not hear the testimony of Mr. Jordan.

I would like to put into the record at this time a statement, plus two statements from people from the State of Kentucky. One is from the automobile dealers' association which points out that Kentucky has lost some 45 dealerships in the last 18 months. Somewhere in the neighborhood of 2,500 have gone out of business nationwide.

There is also a statement from our farm bureau president who points out that the USDA estimates that each percentage point increase in interest cost reduces net farm profit from 5 to 10 percent.

Senator **Weicker**. Those statements will be made a part of the record.

[Material follows:]

STATEMENT OF
SENATOR WALTER D. HUDDLESTON
ON
THE ADMINISTRATION'S POLICY ON HIGH INTEREST RATES

SEPTEMBER 23, 1981

MR. CHAIRMAN, I WOULD LIKE TO THANK YOU AND THE DISTINGUISHED RANKING MINORITY MEMBER, SENATOR NUNN, FOR SCHEDULING THESE TWO DAYS OF HEARINGS ON INTEREST RATES. THE REPERCUSSIONS OF THE STUBBORNLY HIGH RATES ARE SHAKING THE VERY FOUNDATIONS OF OUR ECONOMY AND WE MUST FIND A SOLUTION TO THE PROBLEM SOON. I BELIEVE THAT THESE HEARINGS WILL HELP US FOCUS OUR ATTENTION ON THE DEVASTATING PROBLEM AND CHOOSE THE NECESSARY COURSE OF ACTION WE MUST TAKE IN THE COMING WEEKS.

THE MAGNITUDE OF THE PROBLEM CANNOT AND SHOULD NOT BE UNDERESTIMATED. BETWEEN THE COVERS OF LAST WEEK'S *BUSINESS WEEK* MAGAZINE I FOUND AN ARRAY OF BAD ECONOMIC NEWS WHICH WAS MORE DEPRESSING THAN ANY I HAVE SEEN IN YEARS. I WOULD LIKE TO SHARE WITH YOU A SAMPLING OF EXCERPTS FROM THESE ARTICLES WHICH PLACE IN PERSPECTIVE THE DANGEROUS ECONOMIC FIX THIS COUNTRY NOW FINDS ITSELF IN:

---"CRUSHED BETWEEN PLUMMETING COMMODITY PRICES AND RECORD INTEREST RATES, THE U.S. FARM ECONOMY IS STAGGERING TOWARD ONE OF ITS WORST PERFORMANCES SINCE THE DEPRESSION."

---"AUTO (SALES) WHICH HELPED PROP UP THE SAGGING CONSUMER SECTOR, WILL PROBABLY CRASH IN THE FOURTH QUARTER."

---AND MOST SOBERING OF ALL, "CLEARLY, THE LONG PERIOD OF EXTRAORDINARILY HIGH INTEREST RATES HAS CHOKED OFF ECONOMIC GROWTH AND MAY WELL HAVE TUMBLED THE ECONOMY INTO RECESSION."

AFTER READING THESE AND OTHER ECONOMIC REPORTS OVER THE LAST SEVERAL WEEKS THERE IS NO DOUBT THAT OUR PRESENT ECONOMIC POLICIES HAVE PUT US ON THE ROAD TOWARD A SERIOUS ECONOMIC DISLOCATION.

I BELIEVE THAT THERE IS A GENERAL CONSENSUS IN THE COUNTRY TODAY WHICH ACCEPTS THE FACT THAT SOME SACRIFICES WILL HAVE TO BE MADE IN ORDER TO REDUCE INFLATION AND PROVIDE INCENTIVES FOR ECONOMIC GROWTH. HOWEVER, THE EVIDENCE CLEARLY SHOWS THAT THE HIGH INTEREST RATES BROUGHT ABOUT BY OUR PRESENT POLICIES ARE HAVING A SUBSTANTIALLY DISPROPORTIONATE IMPACT UPON CERTAIN GROUPS WITHIN THE ECONOMY.

THERE IS NO QUESTION THAT THE BRUNT OF THIS BURDEN IS NOW FALLING ON POTENTIAL HOMEOWNERS, SMALL BUSINESSES, SMALL FARMERS, CONSUMERS, THE AUTO INDUSTRY AND SMALL THRIFT INSTITUTIONS. I BELIEVE THIS INEQUITABLE DISTRIBUTION OF THE ECONOMIC BURDEN SHOWS BASIC DISREGARD FOR THE PRINCIPLES OF FAIR PLAY WHICH WE OPERATED UNDER IN THE PAST. AND I BELIEVE THAT WE MUST BRING AN IMMEDIATE HALT TO THE POLICIES WHICH ARE CONTRIBUTING TO IT.

THE HOUSING INDUSTRY IS EXPERIENCING THE DEEPEST SLUMP IN ITS RECORDED INDUSTRY. LAST MONTH'S HOUSING STARTS FELL TO THE LOWEST LEVEL IN MORE THAN FIVE YEARS AND THE PROSPECTS FOR THE FUTURE DON'T LOOK ANY BETTER. MOST OF THIS HAS BEEN BROUGHT ON BY THE EXCESSIVELY HIGH INTEREST RATES WHICH HAVE SHARPLY REDUCED THE FLOW OF MONEY INTO THE HOUSING MARKET.

WHEN HOUSING IS DOWN THE EFFECTS ARE FELT THROUGHOUT THE ECONOMY. HUNDREDS OF HOUSING RELATED BUSINESSES HAVE CLOSED THEIR DOORS AND THOUSANDS OF PEOPLE HAVE BEEN PUT OUT OF WORK AS A RESULT OF THE RIPPLE EFFECTS. AND, MORE WILL SURELY FOLLOW.

HOWEVER, FAR MORE DAMAGING THAN THESE ECONOMIC EFFECTS IS THE REPUDIATION OF THE COMMITMENT THIS COUNTRY MADE TO PROVIDE AFFORDABLE AND DECENT HOUSING FOR ALL ITS CITIZENS. WE HEAR A LOT BEING SAID THESE DAYS ABOUT PRESERVING THE FAMILY, BUT LITTLE CONCERN IS SHOWN FOR THE NEW FAMILIES WHO ARE UNABLE TO AFFORD THEIR OWN HOMES.

THOSE WHO WERE PRICED OUT OF THE HOUSING MARKET BY THE HIGH INFLATION RATES NOW SEE THEIR DREAMS OF OWNING THEIR OWN HOMES FADING FURTHER INTO THE DISTANT FUTURE AS A RESULT OF THE UNCONSCIONABLE HIGH INTEREST RATES.

SMALL BUSINESSES OF ALL KINDS ARE FINDING IT MORE AND MORE DIFFICULT TO SURVIVE BECAUSE OF THE EXCESSIVELY HIGH INTEREST RATES WHICH HAVE DEPRIVED THEM OF NEEDED CAPITAL AND LINES OF CREDIT. DUN AND BRADSTREET REPORTS THAT THE BANKRUPTCY RATE IS UP 42% COMPARED TO THE SAME PERIOD LAST YEAR.

HOWEVER, THE PLIGHT OF THE SMALL BUSINESSMAN IS IN DIRECT CONTRAST WITH THE SITUATION LARGER BUSINESSES NOW FIND THEMSELVES IN. THE CORPORATE LOAN DEMAND FOR LARGER BUSINESSES IS ON THE RISE AND THERE APPEARS TO BE PLENTY OF CREDIT FOR THESE COMPANIES REGARDLESS OF THE NEED.

IN JULY THE HOUSE BANKING COMMITTEE REPORTED THAT "AT LAST COUNT NEARLY FORTY BILLION DOLLARS WORTH OF TAKEOVER LINES OF CREDIT EXIST." WHILE IT IS DIFFICULT TO JUDGE THE MERITS OF THESE MERGERS AND TAKEOVERS, IT DOES APPEAR THAT SUBSTANTIAL LINES OF CREDIT ARE READILY AVAILABLE FOR WHAT SOME WOULD CONSIDER TO BE NONPRODUCTIVE PURPOSES.

IT INCREASINGLY APPEARS THAT WE MAY BE IN AN ECONOMIC SITUATION WHERE SMALLER COMPANIES ARE STARVED FOR CREDIT DUE TO EXCESSIVELY HIGH INTEREST RATES AND LARGE CORPORATIONS ARE TAKING ADVANTAGE OF THE SITUATION TO MAKE NONPRODUCTIVE ACQUISITIONS.

SOME WOULD ARGUE THAT THIS IS THE NORMAL COMPETITIVE PROCESS AND IT IS THE EXPECTED RESULT WHEN THE FREE MARKET IS ALLOWED TO WORK ITS WILL. HOWEVER, I BELIEVE THAT THIS IS NOT A "FREE MARKET" IN OPERATION. THE ADMINISTRATION'S ECONOMIC POLICIES HAVE FORCED UPON US AN ARBITRARILY SET TIGHT MONETARY SITUATION WHICH IS ALLOCATING CREDIT THROUGH HIGH INTEREST RATES TO LARGE BUSINESSES. THIS IS HARDLY A SITUATION WHICH COULD BE CALLED COMPETITIVE.

IN THE AUTO INDUSTRY THE NEWS IS ALSO BAD. ANALYSTS WERE EXPECTING A MODEST GAIN IN AUTO SALES IN AUGUST. HOWEVER, THE EXPECTED 2% INCREASE TURNED OUT TO BE 0.6% AND PREDICTIONS FOR THE FOURTH QUARTER ARE FOR A CONTINUING SLUMP.

NET FARM INCOME FELL 40% LAST YEAR AND THE PROSPECT OF BUMPER CROPS AND THE HIGH COST OF FINANCING INVENTORIES MAKE THE OUTLOOK EXCEEDINGLY BLEAK. FARMERS ARE NOW PAYING ANYWHERE FROM 16 TO 20% FOR FINANCING AND A SUBSTANTIAL PART OF THIS IS ONLY SHORT TERM. IF THE HIGH INTEREST RATES CONTINUE, MANY SMALL FARMERS WILL BE FORCED OUT OF BUSINESS AND ONLY THE LARGER ONES WILL SURVIVE.

TRADITIONALLY, A TIGHT MONETARY POLICY AND HIGH INTEREST RATES HAVE BEEN USED AS THE WEAPON TO FIGHT INFLATION. HOWEVER, WHEN IT IS THE PRIMARY WEAPON AND IS USED TO EXTREME, IT ALSO CONTRIBUTES TO THE INFLATION PROBLEM. THE HIGH INTEREST RATES WILL INCREASE THE NET INTEREST BURDENS ON NON-FINANCIAL BUSINESS ORGANIZATIONS AND THESE HIGHER COSTS WILL CERTAINLY SHOW UP IN THE FUTURE ECONOMY AS HIGHER PRICES.

Balancing the federal budget is another way of fighting inflation, but the excessively high interest rates are obstructing and delaying our efforts along these lines. The high rates mean that when the federal government borrows money to finance the existing debt, it must pay considerably more for that money.

This extra cost is in turn piled on top of the federal debt. Throughout the 1970's the annual net interest rate charges amounted to about 7% of federal expenditures. However, this has now increased to over 12% in FY 1981. The high interest rates are literally adding billions of extra dollars to the federal budget.

While it is obvious that excessively high interest rates are causing the United States severe economic problems, there is disagreement on why the rates are so high. Part of the reason is that the Federal Reserve is carrying out a tight monetary policy which can be expected to result in high interest rates. However, the severity and continuity of these high rates has produced conflicting opinions as to the true underlying reasons.

After reviewing various economic reports I am convinced that all of the fault cannot be laid at the feet of the Fed. Instead it must be traced back to the inconsistent and contradictory economic policy which the administration has put in place.

By the beginning of the August recess the President had gotten everything he had asked for in regard to his economic program. The massive budget cuts had been agreed to and the much more massive tax cut was passed. All of this was done with assurance that this program would stimulate growth, reduce inflation, promote economic stability and balance the budget by 1984.

However, it did not take much time for the illusion created by the Administration to disappear and the realities to sink in. The realities are quite simply that the real figures do not support the rosey picture we were painted by the Administration. The budget deficits, instead of receding into oblivion in 1984, are now growing larger with every new projection. Some economists now believe that it could be as large as $100 billion by 1984. Once Wall Street realized this, we began to feel the feedback in the form of excessively high interest rates which would not come down.

These high interest rates should not be a surprise to most of us since they have been a part of the Administration's economic program for some time. The President has consistently supported them and it is obvious that the Federal Reserve could not continue its extremely tight monetary policy without strong Administration support.

HOWEVER, NONE OF THIS SHOULD COME AS A SURPRISE BECAUSE MOST ECONOMISTS AGREE THAT WITH A STIMULATIVE FISCAL POLICY, THE ONLY EFFECTIVE WEAPON AGAINST INFLATION IS A RESTRICTIVE MONETARY POLICY. THIS DUAL AND INCONSISTENT ECONOMIC POLICY HAS BEEN GRAPHICALLY DESCRIBED BY THE CHAIRMAN OF THE HOUSE BUDGET COMMITTEE AS "THE EQUIVALENT OF STEPPING HARD ON THE GAS AT THE SAME TIME AS YOU SLAM ON THE BRAKES. THE RESULT WILL SOUND SPECTACULAR -- UNTIL EITHER THE BRAKES FAIL OR THE ENGINE BLOWS."

THE AMERICAN PEOPLE WERE PROMISED BY THE ADMINISTRATION THAT IT HAD THE FORMULA FOR STIMULATING ECONOMIC GROWTH, REDUCING INFLATION, LOWERING INTEREST RATES AND BALANCING THE FEDERAL BUDGET. THEY HAVE BEEN DELIVERED HUGE DEFICITS, AND NEAR RECORD INTEREST RATES. ACCORDING TO THE MOST RECENT STATISTICS RELEASED BY THE DEPARTMENT OF COMMERCE WE ARE TECHNICALLY IN A RECESSION.

I DON'T THINK THAT ANY ECONOMISTS, EVEN THE SUPPLY-SIDERS, WOULD DISAGREE WITH THE OBSERVATION THAT IT DOESN'T TAKE A GREAT DEAL OF IMAGINATION OR ABILITY TO REDUCE INFLATION BY INDUCING A RECESSION. HOWEVER, WE WERE PROMISED MUCH MORE BY THIS ADMINISTRATION. IF THE PRESENT ECONOMIC SITUATION IS THE INTRODUCTORY COURSE IN THE NEW REAGANOMICS, I DON'T BELIEVE THAT THE WORKING PEOPLE OF THIS COUNTRY CAN AFFORD TO SIGN UP FOR THE ADVANCED DEGREE.

MR. CHAIRMAN, I AM HOPEFUL THAT THESE TWO DAYS OF HEARINGS WILL ENABLE US TO DEVELOP A NEW ECONOMIC MODEL WHICH RELIES MORE ON LOGIC AND REASON AND LESS ON FAITH AND MADISON AVENUE SALESMANSHIP.

KENTUCKY AUTOMOBILE DEALERS ASSOCIATION INC.
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P.O. BOX 498
FRANKFORT, KENTUCKY 40602
PHONE 502 695 3333

September 18, 1981

The Honorable Walter D. Huddleston
2121 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Huddleston:

Thank you for your letter of September 4, 1981 expressing concern about the excessively high interest rates that this country is having to cope with in today's economy.

I have taken the time to solicit input from our dealer members through the State of Kentucky as to their feelings on this subject. There is no doubt in their minds as you stated previously the members of our industry are facing the most severe economic crunch that has been placed upon our dealers in the history of the industry.

As I am sure you are aware, the "automobile dealer" has been a pillar of his community for years and years. The dealers have devoted their time, money, and expertise to the community, giving the needed leadership in business, civic activities, and financial institutions. They have served as Mayors, city councilmen, on Boards of Education and whatever areas of leadership there are for a community. I guess the point I am trying to make is they are people who do not complain just for the sake of complaining. They are very responsible citizens,and it grieves us to the point where we see a loss of dealerships in our communities, and not only in our communities but over the entire country.

Kentucky has lost some 45 dealerships in the last 18 months, and somewhere in the neighborhood of 2500 have gone out of business nationwide. New car sales in the State of Kentucky dropped in excess of 30% in 1980 and certainly it has not improved this year to date.

Another item that should be of great certain is that in addition to the loss of these dealerships, the tightening of the belts in many dealerships in our State has led to approximately a 30% decline in dealer employees in the past year. I am sure you can see what an impact this has not only at the local, county and state level, but in revenues to the Federal Government. In addition it adds to the unemployment rolls which were already excessive.

KENYUCKY AUTOMOBILE DEALERS ASSOCIATION INC.

NORMAN BOGGESS
President

JACK KAIN
President-Elect

CHARLES W. WEYLAND
Treasurer

JOE L. GOODMAN, JR.
First Vice President

JOHN E. CRONIN
Second Vice President

ROBERT H. NEWBERRY
Executive Vice President

WILLIAM S. COLEMAN,
Field Service Director

JOHN R DAUNHAUER JR
Immediate Past President

ERNIE BATES
NADA Director

In every case dealers have stated that they cannot continue to pay one to two points over Prime (22-1/2%) to floorplan their inventories which can range from $350,000 to in excess of $1,000,000.There is no doubt in their minds that this is a collision course and if it continues for any significant period of time, the numbers aforementioned would be greatly increased.

One dealer stated "I have been in business in the State of Kentucky for 33 years, since 1948, and the automobile business has been very good to me and to my family, but it has gotten to the point where I must make a decision either to invest all my financial gain back into the business or close my doors., and only hope to provide a modest living for my wife and myself for our retirement years. What do I have to show for 33 years of time, effort, reputation, and many tears."

There are many other problems we are confronted with. Not only are the dealers paying 22% for inventory but the rate for retail auto loans is excessive, but we are informed that consumer loan rejections are up and many people who were qualified a short time ago for the new car market are now out of that market.

I do not want to make our case appear like a lost cause, but am only trying to be factual, and we feel something has to be done immediately with the present policy to reduce interest rates as quickly and as substantially as possible to give hope to the survivors in our industry today.

In conclusion, the people we have contacted, without being repetitive say that -

1. by the very fact that the prime rate is over 20% is in itself inflationary.

2. that unless the rate is dropped significantly and quickly, one segment of the free enterprise system as we know it today, the "franchised automobile dealer", will vanish from the market place.

3. If that can happen to our industry, one can imagine what can happen to contractors,realtors, and many other industries in the same predicament we are in. Can our country let all these industries go down the drain simultaneously"

Certainly our Government should take notice of this possible disaster.

Thank you for bringing our interest before the Committee.

Sincerely-

Robert H Newberry

ROBERT H. NEWBERRY
Executive Vice President

Senator **Huddleston**. I have just a couple of questions.

What is the goal that is set for the number of small businesses that have to be put into bankruptcy or put out of business before the economic program that is now in effect works? Have you calculated that?

Mr. **Jordan**. There is no such projection. My own view is it is already far too many.

Senator **Huddleston**. What is your view about how many more there are going to be?

Mr. **Jordan**. I hope not a lot because I hope interest rates come down very quickly.

Senator **Huddleston**. Are you just basing this on hope? Do you realize what is going on out in the country outside of the board rooms of the major financial institutions and the major corporations?

Mr. **Jordan**. We hear much more from small businessmen, from real estate brokers, from farmers than anyone else.

Senator **Huddleston**. Then you know they are going out of business.

Mr. **Jordan**. Yes.

Senator **Huddleston**. How many are you going to tolerate actually being put out of business before you think the situation should change?

Mr. **Jordan**. The situation is changing. We hope it continues to change at a sufficiently rapid pace that this process of getting out of the environment of a high inflationary psychology unwinds quickly.

I do not know any other solution but to convince people that inflation is coming down to stay. As the inflation premium comes out of interest rates, we get the cost of short-term credit down below the cost of long-term credit. We have an inverted yield curve with short-term interest rates higher than long-term interest rates. That has to come out of there.

My father is a small businessman. I hear from him on this problem.

Senator **Huddleston**. I am sure you do. When you talk about the money supply, the foreign central banks, and economic policy, it is somewhat esoteric for our people out in rural America, but they do understand profit and loss and the bottom line.

I do not believe, frankly, that the administration has any realization yet of the severity of the situation that is existing right now. You are not talking about waiting for months or years for some future adjustments until rates finally come down. I am are talking about today, tomorrow, and next week, and the vast number of small businesses that are going to be out of business.

I think someone has already alluded to the fact that when this type of decline starts, you have not only less revenue, you have substantially greater expenses for unemployment and many other assistance programs. It seems to me like the whole plan is on the verge of going totally kaput.

The interest rate is one of the primary things that is causing it. It may be the primary thing as far as many small businesses are concerned. I am wondering if you have any tolerance level at all. Is there any level at which you think that some different approach is going to have to be made?

You say you are opposed to some kind of mandatory reduction in interest rates. What is wrong with having a usury law?

Mr. **Jordan**. That means that no credit is available at all at a low price to small businesses, to home buyers, or to consumers. In that kind of an environment where you have a nonprice rationing scheme and you put a control on the price of credit so you have to use the nonprice rationing scheme, it has always been the larger of the people, those who have access to the international markets, who get theirs. They will probably pay less than they otherwise would. The smaller borrowers only have a chance as long as it is a free competitive market for credit.

Senator **Huddleston**. Does not the policy that is being followed right now represent almost a change in philosophy in this country away from the small entrepreneur, away from the people who are trying to use their energy, their resources, their time, and their talent to develop resources? It is great for the people who have $1 million to put in at 16 percent interest.

Mr. **Jordan**. The big businesses, the wealthy individuals can learn how to beat inflation.

Senator **Huddleston**. They sure can.

Mr. **Jordan**. They can always keep up with it. They can actually make money.

Senator **Huddleston**. They can find $8 billion if they want to buy another company.

Mr. **Jordan**. It is only a sustained anti-inflationary policy, one that brings down inflation and keeps it down, that will help the small business, the farmers, and the home builders.

The housing industry is hurt very much by high interest rates, but in the long run, it is hurt much, much more by inflation.

Senator **Huddleston**. I do not believe that is true. They were selling houses that were inflated twice what you would think they would be. They were selling them like hotcakes when the interest rate was down.

Mr. **Jordan**. However, the prices of houses got way out of the reach of so many people.

Senator **Huddleston**. People are not refusing to buy houses today because of the price of that house. They are not buying it because of the price of the mortgage.

Mr. **Jordan**. The only way we can reduce the price of credit is to also reduce the inflation rate. I do not see that those are separable. We cannot have low-price credit and a high inflation rate.

Senator **Huddleston**. I think in history we have had it. We have had inflation rates that got very high when interest rates were down in the 6, 7, and 8 percent bracket.

Mr. **Jordan**. We had a sharp drop in interest rates artificially created by the credit controls in the spring of 1980. During that period of time, with the sharply dropping price of credit, there was no credit at all available to home buyers, car buyers, or small businesses. The credit available to the consumer, small businessmen, and to anyone who wanted to either build or buy a house was simply nonexistent at a low price because of credit controls and the sharply declining price of credit.

Senator HUDDLESTON. I will not pursue this further, Mr. Chairman. I will defer to Senator Tsongas.

Senator TSONGAS. Mr. Jordan, your background is with the Federal Reserve, as I understand it. Is that correct?

Mr. JORDAN. Much earlier. I left the Federal Reserve in 1975.

Senator TSONGAS. If you were put in a room to determine U.S. economic policy and you could have one assistant, and if you were given a choice of Milton Friedman or Arthur Laffer, who would you choose?

Mr. JORDAN. For one semester, Milton Friedman was a teacher of mine at UCLA.

Senator TSONGAS. Does that mean you would want him or not want him?

Mr. JORDAN. I have very great respect for Professor Friedman. As professional economists, we sometimes will disagree on some fine point, but for the most part, I share his views.

Senator TSONGAS. What I was trying to do—I should have done it more directly—was to determine whether you are instinctively a monetarist or a supplysider. I suppose you would consider yourself a monetarist first and a supplysider second. Is that fair?

Mr. JORDAN. Yes. We coined the term monetarist to simply refer to the application of relative price theory to monetary problems. Supplyside economics simply refers to the application of relative price theory to fiscal policies. I do not see the two as inconsistent at all. They are dealing with different problems with the same tools.

Senator TSONGAS. Let us talk about that. First of all, I have a couple of comments.

Brookings estimates that the increase in the deficit, Senator Nunn, for every 1 percent drop in GNP is $14 billion. There is a clear difference of opinion. I do not know who is right, but I throw that out just for the record.

Second, on the issue of the velocity of money, the velocity that you would have to project to meet those kinds of targets is unprecedented in American history for that period of time, is it not?

Mr. JORDAN. For 1982? No, there are some cases coming on the first year of an expansion where we have had the velocity of that order of magnitude. Also consider that the growth of the velocity associated with the various money measures now is being influenced by the creation of new types of accounts. We have the all-savers certificate coming up. We had NOW accounts introduced last year.

You asked about Professor Friedman. He chooses to emphasize the broad measure of M_2. I find I have more confidence in looking at the monetary base or the narrow measure of M_{1B}, but those are fine points.

Senator TSONGAS. What are your projections as to velocity?

Mr. JORDAN. At this time, I do not have a projection of velocity. At the time the midyear forecast was produced, we did not know what the Federal Reserve's monetary targets were for 1982. Those were announced after we did our numbers and released them.

Now in addition to declining energy prices and trying to account for the feedback effect on real economic activity of lower energy prices, the strong dollar on foreign exchange markets, and the high interest rate, we have to take account of what the Federal Reserve has said they are going to do on monetary policy and what that implies for nominal income and for output next year. We have not completed that process. We are working very hard on it.

Senator TSONGAS. When do you think you will have those predictions?

Mr. JORDAN. They will not be final until December. We will have a tentative set of numbers for internal use by OMB for the agencies, but there will not be a final set of numbers until December.

Senator TSONGAS. The final precomment was that I was intrigued to find an oil glut referred to as a basis of inflation since the last administration always referred to an oil shortage——

Mr. JORDAN. Not to a basis of inflation but to a basis for short-term high interest rates and declining inflation.

Senator TSONGAS. I stand corrected.

Let me read to you from this morning's Wall Street Journal concerning lower inflation and the risk premiums. It says:

> The risk stems in part from the markets' continuing worry that the Federal Reserve at some point will abandon restraint and start speeding the growth of the money supply, with inflationary consequences.
>
> Concern about the Fed hasn't been eased by recent public comments from Treasury Secretary Donald Regan and Murray Weidenbaum, the chairman of the Council of Economic Advisers. They have said the Fed should ease its policy of restraint to some degree.

Mr. JORDAN. That is not at all what Murray Weidenbaum recommended. What he stated was that for the Federal Reserve to hit their targets for this year (which they have continued to repeat their determination to do), since the most recent figures from July and August on the narrow measure of money are slightly below their targets, the rate of increase on a short-term basis might look fairly high compared to what we have been experiencing.

He just wanted to caution people that if you do see an acceleration in monetary growth, that should not be interpreted as a caving-in on the determination to fight inflation, that the administration understands that money growth has to be a little faster in the short runs just to hit the targets, but it should not mean that the long-run deceleration of monetary growth, the commitment to reduce inflation is being abandoned.

Senator TSONGAS. That is consistent with what you said to Senator Nunn. In response to Senator Nunn, you said the tax policy is not stimulative. Is not the great supply side miracle conditional upon growth caused by the tax cut? Is not growth the same as stimulation?

Mr. JORDAN. That is a refinement or a clarification that is useful. It is stimulative to real output in the investment sector in combination with spending cuts in an anti-inflationary environment. If you had the tax cuts alone, the tax rate reduction, without the spending cuts, then I do not believe it would stimulate anything, nominal or real. There is no such thing as a tax cut without a spending cut. You change the form of taxation. You defer it. You cause inflation, but you do not really avoid it.

The spending reduction in combination with the tax rate reduction, putting a ceiling on tax revenue, will stimulate real output growth in an environment where inflation is coming down in the investment sector.

Senator TSONGAS. You presume the budget cuts.

How do you feel about the U.S. spending a quarter of a trillion dollars on defense in fiscal year 1984? Is that Government spending?

Mr. **Jordan**. It is Government spending.

Senator **Tsongas**. Do you think that is excessive?

Mr. **Jordan**. I do not know quite how to answer that question.

Senator **Tsongas**. If you do not, who does?

Mr. **Jordan**. The commitment that I think came out of the campaign last year was that the United States. was going to raise Government spending as the share of national income for military purposes from 5 percent of GNP to 7 percent. That 7 percent in that context is a share of GNP.

Given the economic assumptions and projections that the administration has been working with, and, in a sense, working back from the 1986 time horizon, a growth pattern of 7 percent growth per year in real terms from 1982 forward was derived. That came on a base of a very significant catchup increase from, first, 1979 to 1980, and then from 1980 to 1981, and, further, from 1981 to 1982. That 7 percent from that high 1982 level produces the figure you refer to in 1984.

If it is the judgment of the Congress and of the people largely that that kind of rate of increase from the 1982 level cannot be made compatible with all of the rest of the economic program, you can still have a significant military buildup and, in fact, 7 percent real increase over this whole period of either 1980 to 1986 or 1981 to 1986 and come up with a much lower target in 1984 and a lower accumulated outlay over the 3-year period we are talking about.

Senator **Tsongas**. The premise that you as a monetarist work from is the campaign commitment to have 7 percent of GNP allocated for defense. Is that right?

Mr. **Jordan**. It is a question of if you are going to spend 2 percentage points more of national income on one purpose, you have to spend 2 percentage points less on something else.

Senator **Tsongas**. How about social security?

Mr. **Jordan**. Social security has been over indexed in the last 5 years. The real shocks, the oil price increases of 1974–75 and then again in 1979–80, caused significant real increases in social security outlays, unintended social security outlays.

Senator **Tsongas**. Have you recommended to the President that social security, the increase, be reindexed?

Mr. **Jordan**. The issue of indexation in all of the entitlement programs and some options have been discussed. There have been no decisions about that, but we have pointed out the over-indexation, the increases in real benefits that Congress did not vote for. I think that is the responsibility of Congress, but real benefits increased for purely statistical reasons. I think that that was not intended.

Senator **Tsongas**. You would not be unhappy to see Congress cut social security I take it.

Mr. **Jordan**. Cut social security indexation?

Senator **Tsongas**. Yes.

Mr. **Jordan**. I do not think a reduction in current social security outlays is desirable. I think the rate of increase in the future based on the Consumer Price Index could be adjusted to bring it in line with what is going on in the real economy. If real wages of the workers are not going up, I am not sure that Congress intended that the real benefits of the people on transfer programs was supposed to go up. If the whole pie is not growing but some are getting a bigger share, somebody else has to get a smaller share.

Senator **Tsongas**. That is your personal feeling, but it is not the feeling of the administration.

Mr. **Jordan**. Excuse me?

Senator **Tsongas**. It is not the feeling of the administration. They have not come out with that.

Mr. **Jordan**. That is right. They have not come out with that.

Senator **Tsongas**. Let me say that you certainly have an interesting job ahead of you in the next couple of months in reconciling all of this. I would hope there would be some kind of hazardous duty pay allocated for those of you who have to defend it.

Thank you.

Mr. **Jordan**. Thank you.

Senator **Weicker**. Senator Baucus?

Senator **Baucus**. Mr. Jordan, I have the same basic doubts about this economic program as do other Senators on this panel, judging from the questions they have asked.

In addition, I am concerned about what we are going to do from here generally because I think that the present program is probably not working very well. At least there are a lot of doubts about whether it is working. The question is what to do about it.

I was talking to a corporate financial officer a few days ago. He told me that any corporate financial officer worth his salt, particularly following this new tax cut, is going to have to show zero income tax if he is going to keep his job. That is, the tax bill is so lucrative and so beneficial to most businesses that as a result the revenue shortfalls will be even greater than expected. Corporations are going to bend over backwards to show that they do not have to pay income taxes because of the provisions of the tax bill.

In addition to that, I am sure you noticed in this morning's paper that a poll conducted by the Washington Post showed that to a very significant degree Americans are beginning to think that the spending cuts are too great, that they are weighted too much against middle Americans, average Americans, and that the administration program is generally tilted to the wealthy and big business. That is a very significant growing perception in the country, at least as indicated by the polls in this morning's paper.

On top of that, another morning paper, the Wall Street Journal, indicated that most economists expect interest rates to rise. There is a shortrun dip in those rates, but most economists expect interest rates to rise, or at least not to decrease to any significant degree.

I think there is a very strong argument that all of these concerns have a lot of validity, and that we can expect that revenue shortfalls will be very great next year, and that the public's perception is beginning to solidify against further spending cuts, particularly in social programs. On top of that, the administration wants to spend more on defense, above the 5 percent planned by President Carter. The administration is running into the Carter defense programs and it has to spend more than the Carter program of 5 percent at least to save face. If any of those assumptions are accurate, what do we do from here? What do we do at this point?

Many people have suggested to me that we should defer or roll back the income tax cuts. One could get into a discussion of whether it is individual taxes or business taxes or some combination which deserve attention, but people privately, and Wall Street, seem to be somewhat interested in this process and suggest that perhaps we should lower interest rates, to lower inflation expectations, and that maybe that tax bill was just a little bit too much, a little bit too big. Maybe it makes more sense to defer or roll back tax cuts.

I am interested in what your analysis and answer to that is.

Mr. **Jordan**. First, on the ability of businesses to reduce their taxation to effectively zero, for that to be possible, they have to incur very considerable expenditure on new plant equipment or refurbishing old facilities.

Senator **Baucus**. Which is what the administration supplysiders want.

Mr. **Jordan**. Therefore, the job creating effect of the investment that would take place of the business sector of trying to reduce to their taxation to zero would be a tremendous increase in employment and personal income.

You cannot look in a static sense and say we are not going to have the revenue coming through the business side, tax on the owners of capital, without looking at the effects on overall economic activity. I really do not view that as a negative.

Senator **Baucus**. You do expect the shortfall perhaps to be even greater in corporate income taxes?

Mr. **Jordan**. No, not compared to the numbers that we have because we have a very significant pickup in investment.

What is hurting us most on the revenue in the short run is inflation is coming down. The worst things that can happen to the budget are all good for the people: Lower inflation; lower food prices, meaning less farm income and less tax on it, more outlays for the Agricultural Department, and the only people who gain are the people; declining real energy prices, which means less windfall profits tax and nobody but the people gains from that——

Senator **Baucus**. I wonder if you would generally address the question I asked. Why not modestly defer a rollback in the income tax so that we do not have such a large deficit?

Mr. **Jordan**. What the tax program did was stop tax revenue from rising as a percent of GNP. It held it at the 20-percent level. It does not cause it to go down. It just stops it from going up. To roll back the tax——

Senator **Baucus**. I am not saying 100 percent, but to give a signal that we will try to reduce the deficit.

Privately, most people tell me that business feels guilty about this. They got more than they bargained for. They think it is too big for the good of the country, at least in this period of time.

Mr. **Jordan**. If they engage in the kind of spending and the job creating activity that that implies, I do not think that is a bad thing. I do not think the increases in employment which would result from that would be considered a bad thing.

A vote to roll back the tax increases would be a vote for a relatively larger Government sector, more of the Nation's resources, to flow through the Government rather than to be left in the private sector. I think the decision to hold tax revenue at the 20-percent level—it is not a reduction in the share of tax revenue percentage of GNP, but is just drawing a line and saying that we are going to bring spending down to that level—was, I think, an action that can have a very stimulative effect and create rising productivity and increasing standards of living in the future.

In a sense, we do not have an effective constituency for the future standards of living, for rising income levels in the future. That is what this tax bill did.

Senator BAUCUS. I just wonder perhaps if the tax bill's direction is accurate. Perhaps it should be phased in slowly because it is going to cause such a big drop in revenues.

I understand, too, as I think Senator Nunn pointed out, that you are hoping that the tax cuts are going to drive through the spending cuts. I think we all feel there should be some spending cuts, but I am just pointing out the realities.

It seems to me that the country, and certain Republican leadership in the Congress, is resisting spending cuts, at least to the degree that the administration seems to be moving toward. There are going to be some problems.

Let me move to another area. That is the feeling I have that this administration is so much geared toward free competition and free market that the end result is going to be that the big just get bigger and the small get smaller. There is such a distinct orientation, such a wealthy, rich guy orientation.

In talking to small businessmen, farmers, and ranchers in my home State of Montana, I know that they are not getting bigger and wealthier off of all of this. I am wondering if perhaps it does not make more sense from a public policy point of view not to go so far and to such a great extreme in pursuing the good of free market and free competition. Why can there not be some compromise here to help small business?

As you know, this tax bill is geared much more toward big business than it is for small business.

Mr. JORDAN. There is a lot in the bill for small business.

Senator BAUCUS. There is a lot, but you have to agree with me that big business is helped more.

Mr. JORDAN. That is because of inflation. Inflation is an extremely devisive force. It transfers resources within the economy. It favors debtors at the expense of creditors. It favors big over small. It certainly transfers in favor of the Government sector away from the private sector generally, but within the private sector, the wealthy can benefit from inflation. They can figure out ways to beat inflation and to even profit by it. The low income cannot. Renters cannot gain from inflation. They lose.

Senator BAUCUS. Small business cannot gain by inflation either.

Mr. JORDAN. He cannot gain by inflation. He loses.

Senator BAUCUS. He is not doing well under the present administration program.

Mr. JORDAN. The present administration program is to take a legacy of rising inflation driven by rapidly growing Government and too much monetary creation, turn that around, impose some fiscal discipline, bring down monetary growth, reduce inflation, and we think that will help small business, farmers, home builders, and consumers.

We think that we could put the homebuilding industry through another feast-famine cycle. You could have a massive dose of stimulus or programs to stimulate housing, drive them up to the 2 to 2.5 million unit rate of construction per year, and then down they go again. We have had several years of that.

However, if we bring inflation down and interest rates down because inflation comes down, then you can have several years of year-in-and-year-out 2.5 million units.

Senator Baucus. I am obviously not going to convince you, and I do not think you are going to convince me. We do not have much time this morning, but I would just suggest that the administration find a program which is a little more fair.

I think that Americans are willing to undertake measures that have to be undertaken to stop the inflation we have and the interest rates we have so long as it is perceived as fair. I respectfully suggest to you that the present program is in fact not very fair. It is tilted toward one segment of the country and helps that segment far too much at the expense of the other. That is the growing perception.

Mr. Jordan. I think that that perception is a problem we have to deal with.

Senator Baucus. Thank you, Mr. Chairman.

Senator Weicker. Thank you very much, Mr. Jordan. I appreciate your comments. You have been very patient and very precise in your responses. Obviously there is a difference of opinion here, but I certainly think the subject has been pretty well aired. Thank you for your testimony.

Mr. Jordan. Thank you, Mr. Chairman.

[The prepared statement of Mr. Jordan follows:]

For Release Upon Delivery
9:00 a.m., September 23, 1981

INTEREST RATES AND BUSINESS CREDIT NEEDS

STATEMENT

OF

THE HONORABLE JERRY L. JORDAN, MEMBER
THE PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

BEFORE THE

SENATE COMMITTEE ON SMALL BUSINESS

September 23, 1981

Mr. Chairman and Members of the Committee:

Thank you for inviting me to appear before the Committee today to address the problem of interest rates and the credit needs of small businesses. This is an area of considerable interest to the Administration, as we recognize the importance of small business to the vitality of the economy, and we recognize the dependence of small business on external finance. In addressing this topic there are several points which I hope will help the committee in understanding the issues as we see them.

- High interest rates are, at the moment, a serious problem -- but they are a temporary problem. The Administration will continue to show its determination to reduced Federal spending and Federal credit demands. As it does so, interest rates will come down. And, as the President's broader program takes effect, rates will stay down.
- Inflation has been a long-standing and chronic problem, much more harmful to small business than current high interest rates. The President's program is aimed at reducing inflation, which only can be achieved by reducing money growth. For this reason, we feel that, in the end, small business will especially gain considerably by the monetary portion of the program even though there are short-run adverse affects of high interest rates.

- Although the transitional effect of the monetary component of the President's program is creating problems, there is much in the program that provides immediate benefits to small business. In particular, the recently enacted tax package and the agenda for regulatory review and reform provide billions of dollars of capital to small business. This is a long-term improvement in the business climate that starts now.
- There are *longer term* problems of small business financing that require study. With the introduction of wider competition into financial markets, credit that once was rationed at the discretion of individual bankers may now be more sensitive to interest rates. This may cause small business to pay high, market-sensitive prices during periods of credit restraint. As directed by Title V of last year's amendments to the Small Business Act (P.L. 96-302) the Comptroller of the Currency, the FDIC, and the Federal Reserve are currently undertaking a complete review of this matter. Their report is expected to be completed early in 1982, and the Administration will give prompt attention to their findings.
- Finally, it would be a grave mistake to opt for credit controls either as a solution to the short-term problem or as a cure for the longer term problem of financing small businesses.

High Interest Rates and Small Business

Interest rates are extraordinarily high by historic standards. Frankly, although there is a good deal of anecdotal evidence that the adverse effects of these rates on small business is disproportional, we have no good statistics to back up these assertions, and no economic analysis to say exactly what happens and why. I will come back to this problem of our lack of data.

Right now, some of the best comprehensive evidence we do have on the current state of the small business sector is contained in the quarterly survey of the National Federation of Independent Business. In the quarterly survey for July, interest rates and financing became the single most important problem facing small business, according to the survey. High interest rates were cited by some 31 percent of respondents as their single most important problem in the second quarter. In the past, financing problems have been cited as the number one problem by only about 10 percent of respondents. This is the first time in the seven-year history of the survey that "interest rates-financing" have been cited by a plurality of firms as the single most important problem facing small business, according to the authors of the Survey, Professor William Dunkelberg of Purdue and Professor Jonathan Scott of Southern Methodist University.

Why are rates so high? For twenty years successive Administrations and monetary authorities have alternated between the fight against inflation and temporary measures to shore-up employment. Although such measures have had no permanent effect on unemployment, they have given us a legacy of continuing inflation and, most important, expectations of inflation. Every program to fight inflation is justifiably regarded with skepticism, and it will take a continued application of an effective anti-inflation program to relieve that skepticism.

It is widely known and accepted among economists that the root cause of long-term inflation is the excessive growth of money and credit. There is no way to make permanent headway against inflation except by reducing money growth. We are firm and resolved in our support of the Federal Reserve's actions to achieve that end.

In the same vein, we are determined to relieve the long-term pressure on the monetary system of supporting a swollen Federal budget. Attention has been focused recently on projections of the deficit that seem to suggest we may falter in our determination to achieve a balanced budget by 1984. I want to caution everyone to remember that deficit projections are always changing. Each represents only a way station, and often only an imaginary way station, on the road to fiscal prudence. We are maintaining constant pressure throughout the government to bring down spending. We will continue to do so. In this light it is interesting to note that, as much as anything, it is the skepticism of investors that is pushing to destroy that one goal they most wish the

President to achieve, since much of the external pressure on spending is coming from interest rates.

A number of analysts have recently pointed to the President's program of tax cuts as somehow being "excessive". That simply is not true. At the same time as we reduce inflation, we must restore the potential for economic growth that has been stifled by an excessive tax burden. We just cannot wait until we have cured inflation to begin restoring the economy's strength. And in that vein, the reduction of tax revenues provides the greatest possible incentive for reducing government spending.

However attractive the benefits, some will argue that the price -- temporarily high interest rates -- is too great to pay, that interest rates themselves will choke off the growth we so badly need in the small business sector. Let me remind you that inflation is the number one long-term problem. Citing again from the Small Business survey, up until July of this year, inflation has been cited by more firms as the number one problem than any other difficulty. And even when interest rates are the worst problem, being cited as such by 31 percent of firms, inflation was still cited as the worst problem by 26 percent of the respondents! Thus, while high interest rates capture the headlines, inflation remains the continuing danger. Our program is aimed at this long-term problem.

Small Business and the Economic Recovery Program

We should not focus only on the transitory pain of high interest rates in judging the President's program and its effects on small business. I confess, it is all too human to take the good for granted and complain about the unpleasant, so I think it is essential to look at the other features of the Program and their impact on small business. It is hardly a bed of thorns. In particular, a number of features of the tax package provide significant benefits to small business. Furthermore, the Task Force on Regulatory Relief, headed personally by the Vice President, will be reviewing many of the most onerous regulations faced by small business.

First, the Tax Act. I don't think the Administration has yet done enough to point out the opportunities the recent Tax Act offers for small business. The tax reduction for small business alone is on the order of $2-1/2 billion in fiscal 1982 and $8-1/2 billion by fiscal 1986. A full explanation of the bill's attributes in this area is properly within the responsibility of the Treasury, and I have appended to my testimony such an analysis prepared by them. Let me just point out a few of the high points. First, a very high proportion of small business income is taxed as personal income. This is very often overlooked, so it is no surprise that the importance of across-the-board reductions in the personal income tax have not been discussed. Indeed, I have not included the share of personal reductions for small business in the figures I just gave you. Second, a number of features of the new cost recovery system are advantageous to small business, both as incentive to invest and because they reduce costs by simplifying bookkeeping. Third, and the last I will mention, are estate and gift tax relief. People who go into business for themselves work very hard, and the pressures of operating a small business rarely allow time for relaxation. Many people build up their businesses with the thought that, although they may not get a chance to enjoy the benefits of the wealth they have accrued, their children will. The desire to leave a family business to one's children should not be underestimated as one of the rewards entrepreneurs seek. Thus, the dramatic reform of the estate and gift tax may provide a very direct improvement in the small business environment.

As I have said, the Administration's regulatory relief program is also of special benefit to small businesses. Many regulations are simply more burdensome for small business than for larger businesses. For example, the paperwork or the investment required to meet regulatory goals may not be tailored properly to firm size and ability to pay, or some regulatory goals may be achievable more cheaply where large production runs allow the cost to be spread. Taking this into account, any attempt to reduce the regulatory burden is bound to be especially beneficial to small business, even if particular regulations were not reviewed on the basis of their impact on small business. It is therefore not surprising that the Vice President's March 25 list of 27 existing regulatory programs targeted for review include several, like EPA effluent guidelines, EEOC guidelines on employee selection, FTC prenotification rules and reports, and Treasury LIFO inventory accounting rules, all of which have disproprotionate costs for small business. But, in addition to this more general review process, the Administration is seeking the special input of small business. The Department of Commerce is compiling a list of those regulations which have the greatest impact on small business. To do so, information will be gleaned from complaints and recommendations heard over the Department's small business "hotline".

Measuring the Effects of the Program

It should be clear to all that the long-run effects of the program will be salutary for small business. On net, small business should benefit even in the short run. Unfortunately, putting on my hat as an economic analyst, I can't say how big the benefits are: how many jobs will be created, how much sales will be improved, how many new innovations will result. The problem is that for years -- perhaps since the dawn of civilization! -- many have argued that small business is special, and has unique problems. I am inclined to believe this, but, I am sad to say, there is no good, hard evidence of this of the kind we economists can use to analyze the problems and to propose solutions. For this reason the actions mandated by the Congress last year in P.L. 96-302 are especially important. First, and perhaps most important, the law laid with the Administrator of SBA the responsibility to keep and publish a small-business data base. Such a data base is long overdue, and I am happy to report that, according to all I have heard, SBA is making rapid progress in gathering the data. Of course, it will be a long time before this data base is complete and comprehensive. Second, the law mandated an annual report from the President on small business. I think this may offer the opportunity for an annual review and synthesis of policy discussions that have too often been fragmented.

Finally, and most apropos of today's discussion, Congress mandated a full-scale review of the credit needs of small business. This study is being carried out by the Comptroller of the Currency, the Federal Reserve Board, and the FDIC, with the advice of SBA and the Census Bureau. I am informed that this study is expected to be delivered to the Congress on February 1. For me as a longstanding student of the operation of the credit markets, the results of this study should be particularly interesting. For example, the authors of the quarterly survey of the Federation of Independent Business, which I cited at some length earlier, remark in a press release that "credit is widely available (although at a high price)". Although as I have said, there are no hard data, it seems to me this is a very different situation from what was the case even a few years ago, when tighter credit conditions often meant that credit was not expensive, but it was also not available. I hope we can learn about this from the Credit Needs Study.

The Danger of Credit Controls

The fact that we expect the current period of high interest rates to be short-lived, the fact that the President's Economic Recovery Program is likely to be of extraordinary benefit to small business, and the fact that alleged structural problems in financing small business remain unproven or, at best, ill-understood, all argue against taking any precipitate special action to relieve the pressure of high interest rates on small business. Unfortunately, one all too often hears the suggestion that we ought to short-circuit the financial markets and have the government step in to ration credit directly.

No policy could be more ill-advised. First of all, credit controls do not make more credit available. The only ways to make more credit available are to increase savings or to return to the fast and loose policies of money and credit creation that brought on inflation. Our economic program is designed to spur savings. It will take some time for the effects of that program to become evident, however. In the meantime, it would be a mistake to impose credit controls. All credit controls can do is reallocate credit among borrowers in some way other than the market would have done. Those who get the credit get it cheaply, but those who don't get it, don't get it at any price. Not only is this unfair, it is just simply a bad way to operate an economy. Since the end of World War II, our Federal government has had a very difficult time managing its own finances. I see no evidence that we can manage the private sector's finances any better. If there were need for immediate proof of this assertion, I only need to remind you of what happened in the second quarter of 1980.

TAB A

SMALL BUSINESS PROVISIONS OF THE ECONOMIC RECOVERY TAX ACT OF 1981

Department of the Treasury, Office of Tax Analysis

September 1981

Small Business Provisions of the Economic Recovery Tax Act of 1981

In addition to the broad benefits of individual rate reductions and accelerated cost recovery, the Economic Recovery Tax Act has a number of provisions of special interest to small businesses. It provides rate reductions for small corporations, reduces or eliminates estate and gift taxes on transfers of family-owned businesses, allows for limited expensing of machinery and equipment purchases, increases tax-deductible retirement savings for the self-employed, and includes a number of other tax-reduction measures. Altogether, the provisions total about $2.3 billion of small business tax relief in 1982 and $8.6 billion by 1986. The specific provisions are:

- o Estate and gift tax relief. When fully effective, transfers of up to $600,000 will be free from tax and the top estate tax rate will be reduced from 50 to 70 percent. No transfer tax will be imposed on gifts and bequests between spouses. Special use valuation will be applied to more farms, small businesses, and woodlands and may reduce taxable estates by up to $1 million. These changes will greatly reduce the hindrance of the transfer taxes to the building and maintaining of small family businesses.

- o Increase in Keogh plans. The limits on deductions for contributions by the self-employed to a retirement plan will be increased from $7,500 to $15,000.

- Expensing of capital investment. Expenditures for machinery and equipment may be written off in the first year up to an amount of $5,000 for investment in 1982 and 1983, $7,500 in 1984 and 1985, and $10,000 thereafter. This provision will further simplify tax acccounting for small businesses and provide immediately the additional incentive and cash flow for their modernization and expansion.

- Increased investment credit for used property. Many small businesses conserve scarce capital by purchasing used machinery and equipment. The amount of these purchases eligible for the investment credit will be raised from $100,000 to $125,000 for 1981-1984 and $150,000 thereafter.

- Liberalized accumulated earnings tax. Earnings may be retained in a corporation up to at least $250,000 without incurring an accumulated earnings tax. The bill raises this minimum amount from $150,000.

- Write-off of operating rights for motor carriers. Deregulation of the motor carrier industry dramatically reduced the value of certificates of operating rights which had been an important asset for many small trucking companies. As partial compensation the bill allows these losses to amortize the basis of those rights over a 60-month period.

- Reduction of the Windfall Profit Tax. The tax burden will be eliminated or reduced for small royalty owners and oil production incentives will be restored for independent oil producers by changes in the windfall profit tax. These changes include a credit of $2,500 against the tax liability for royalty owners for 1981, to be replaced by exemption from tax of two barrels per day in 1982-84 and exemption of three barrels per day thereafter. Stripper oil production of independent producers will be exempted from the windfall profit tax beginning in 1983.

- Liberalized Subchapter S. The maximum number of shareholders allowable in a corporation whose owners choose to be taxed as individuals under Subchapter S was increased from 15 to 25. In addition, certain kinds of trusts will be allowed to be as shareholders in such corporations.

- Incentive stock options. Start-up businesses will be aided by a provision to allow employees to be taxed at capital gains rates upon sale of stocks acquired through incentive stock options. This provision will help such businesses to attract key employees who might otherwise be too costly.

- Simplification of LIFO. The bill makes changes, and authorizes regulations to make further changes, to simplify and remove impediments to the use of the LIFO inventory method by small businesses. These changes will help to remove a tax on overstated profits due to inflation and thereby provide needed cash for the growth of small businesses.

Tax Reductions for Small Business in the Economic Recovery Tax Act of 1981

($ billions)

	Fiscal Years				
	1982	1983	1984	1985	1986
Estate and gift tax provisions	-0.2	-2.1	-3.2	-4.2	-5.6
Increase Keogh plan limit to $15,000 (January 1, 1982)	*	-0.2	-0.2	-0.2	-0.2
Phased-in expensing of assets: $5,000 in 1982 increasing to $10,000 by 1986	-0.5	-1.0	-0.9	-0.8	-0.3
Small business corporate tax rate reduction (January 1, 1982)	-0.1	-0.3	-0.4	-0.5	-0.5
Increase used property limit for the investment tax credit to $125,000 for 1981-1984 and $150,000 thereafter	-0.1	-0.1	-0.1	-0.1	-0.2
Increase accumulated earnings credit to $250,000 (January 1, 1982) and liberalize Subchapter S rules	*	-0.1	-0.1	-0.1	-0.1
$2,500 windfall profit tax credit for royalty owners for 1981, replaced by exemption of 2 barrels per day in 1982 through 1984 and 4 barrels per day in 1985 and thereafter	-1.2	-0.8	-0.9	-1.1	-1.1
Exempt stripper oil production by independent producers (January 1, 1983)	-	-0.3	-0.4	-0.4	-0.4
Write-off of motor carrier operating rights	-0.1	-0.1	-0.1	-0.1	*
Stock options	*	*	*	*	*
LIFO inventory simplification	-0.1	-0.2	-0.2	-0.1	-0.1
Totals	-2.3	-5.2	-6.6	-7.8	-8.6

Office of the Secretary of the Treasury
Office of Tax Analysis

August 3, 1981

* Less than $50 million.

Senator **Weicker**. The next witness is Frederick Schultz, Vice Chairman of the Federal Reserve Board.

Mr. Schultz, I apologize for keeping you waiting, but, as you can see, there is great interest on this side of the table as to those who are testifying before the committee.

Please go ahead and deliver your statement as you see fit. Then stand back and get ready to catch what comes flying across the table here. Your complete statement will be made a part of the record following your presentation.

STATEMENT OF FREDERICK H. SCHULTZ, VICE CHAIRMAN, FEDERAL RESERVE BOARD, WASHINGTON, D.C.

Mr. **Schultz**. Mr. Chairman, let me start out by saying that none of the seven members of the Federal Reserve Board likes high interest rates either. High interest rates clearly indicate that the economy is not working right. We have very high levels of inflation, and, quite frankly, I think the next 6 to 9 months are going to be critical in the history of this country. It is not going to be easy.

I appreciate the opportunity to participate in this hearing on the impact of high interest rates on small business. Driven principally by rapid and persistent inflation, interest rates have been at extraordinarily high levels through much of the past several years, causing serious problems for many sectors of the economy.

Because small businesses account for the vast majority of the firms in this country today, and operate in all areas of the economy—in both a geographic and business sense—it is not surprising that they are feeling the effects of the high rates. Moreover, there are some reasons to believe that small businesses may be more vulnerable to the adverse consequences of credit stringency than are larger firms. Recently, Chairman Volcker sent a report on the impact of high interest rates on small business as well as on the auto, housing, and agricultural sectors to the Senate Committee on Banking. I have submitted that report with my statement and, and as basis for discussion at this hearing, I would like to highlight and elaborate on some of the major points made in it concerning small businesses.

One, small businesses typically depend relatively more on debt financing than larger firms since their sources of equity capital are more limited. As a result, small busineses tend to have higher ratios of debt to equity, and the interest on the debt of small firms likely absorbs a relatively larger portion of cash flow than for similarly situated larger firms. The squeeze on cash flows of smaller firms can be especially intense if competitive pressures and sluggish demand prevent them from passing along the full cost of higher interest rates to their customers.

Two, small businesses tend to rely on commercial banks to meet their credit needs. This suggests that the impact of high interest rates on this sector depends to a great extent on the cost and availability of loans at banks and on the relationships between small businesses and their banks.

Three, direct information on the terms of bank loans made to different size businesses is not available, but data from the Federal Reserve Board's survey of terms of bank lending show that rates on small loans have risen less than those on large loans over the past several years. Moreover, in recent surveys, the average levels of rates on small loans at small banks, the type usually going to small businesses, have been generally about the same or even lower than the rates charged on larger loans at large banks. Of course, these data do not reflect the ability of large businesses to reduce borrowing costs by accessing other markets, where rates at times may be more attractive.

Four, problems of credit availability do not appear to have worsened markedly for small business this year. This is in contrast to earlier periods of high interest rates, when lending at banks—especially small banks—was severely constrained by difficulties they faced in attracting funds because of limitations on interest rates they could pay on deposits. In these circumstances many small businesses encountered trouble obtaining credit at any price. More recently, with restraints on the rates banks can pay somewhat more relaxed, most small businesses have access to credit, if they are willing to pay the price In addition, a number of banks throughout the country reportedly have been making special efforts to be more flexible in meeting the needs of small businesses, a practice which the Federal Reserve System has consistently encouraged.

Five, although I am confident that our assessment of the current status of bank lending to small businesses is reasonably accurate in broad outline, we are aware of our lack of more detailed knowledge of this crucial relationship. In that regard, the Board, in conjunction with the interagency task force on small business finance, is currently in the process of conducting a personal interview survey with lending officers at 250 banks throughout the country on commercial bank small-business lending practices. The interviews include questions on availability of credit to small businesses, loan characteristics, pricing and profitability, and use of Government programs. The information gathered from the interviews will give us further insight into the effects of current credit conditions on small business. A report on the results will be sent to the Congress in early 1982.

Six, finally, I am encouraged by reports that many firms are learning to cope with the adverse financial and economic environment through such means as improving their product pricing strategies, cutting costs, reducing inventories, and managing cash more closely. Nonetheless, the large increase in bankruptcy filings since early 1980 is an indication of the difficulties being experienced by a number of small businesses. Of course, the bankruptcy numbers reflect not only problems related to high interest rates, but also those related directly to inflation and sluggish economic activity, as well as the liberalization in the bankruptcy code effective October 1979.

In sum, small businesses, along with larger businesses, households, and many lenders, are facing a very trying situation, the proximate cause of which seems in large measure to be high interest rates and intense competition in the credit markets for a limited supply of funds.

Moreover, many have asserted that this situation can only be worsened by the recent surge of bank lending activity associated with mergers among some very large firms. The loans and commitments involved are extremely large, and some have concluded that funds advanced for this purpose will not be available for any other use—such as for lending to smaller businesses.

In my view, any effects from this activity are easily exaggerated. First, the volume of credit involved is not that large relative to total flows; the actual amount of loans taken down for takeover purposes appears to be much less than the reported credit lines, in part because a number of the lines were related to the proposed takeover of the same company. Second, and more importantly, these loans and the transactions they finance do not in any fundamental sense use credit in such a way as to make it unavailable to other borrowers. The actual transactions involved in the mergers merely result in a transfer of financial assets; the acquiring company borrows money from the bank to pay the stockholders of the acquired company. The stockholders then likely reinvest the money or repay debt, recyling the funds through the financial markets. I recognize that in the short run these loans could have some impact on the distribution of credit, possibly affecting its cost and availability for other bank customers. But, I believe that in a freely operating financial system any distortions of this sort are likely to be small and short-lived.

The problems facing small businesses are not related to takeover lending; they are not even caused in the most fundamental sense by high interest rates. Rather, the principal source of their current difficulties is the extraordinarily high and persistent level of inflation our country has experienced in recent years. Inflation has a very direct and immediate effect on the entire cost structure of industry. Increases in labor and other input costs likely have a much greater impact on the earnings of small businesses than do rising interest rates. Recognizing this fact, small businesses until very recently have identified inflation, not credit costs, as their principal problem.

Moreover, high interest rates themselves are primarily a necessary and unavoidable consequence of rapid inflation, augmented under current circumstances by anticipation of large Federal deficits. Only in recent months have price increases shown significant moderation from the double-digit rates experienced in the last 2 years. The virulence of actual inflation and expectations that it will continue at a high rate have prompted lenders to demand interest rates high enough to compensate for the declining purchasing power of the dollars they lend. Expectations of price increases also weaken borrowers' reluctance to pay high interest rates. The impetus needed for a significant and lasting decline in inerest rates is a continuing slowdown in the actual rate of inflation and a conviction by both borrowers and lenders that those making monetary and budget policy will not allow the rate of price increase to reaccelerate.

Because of the problems inflation has brought to our economy, it is imperative that the Government implement policies that focus on bringing the inflation rate down—and keeping it down. For its part, the Federal Reserve has been seeking a gradual moderation over the longer run in the growth of the money supply. As this policy bears fruit, we are confident that the result will be reduced pressures in the credit markets and an eventual decline in interest rates.

We realize that the adjustments required will be painful; we should not expect the reversal of a 15-year trend of accelerating inflation to be accomplished quickly and without unpleasant side effects. The process of adjustment to a noninflationary environment can be made less painful, however, if the Congress and the administration hold down Federal Government spending. The tax cuts that already have been legislated need to be balanced by additional expenditure cuts. If further spending cuts are not made, pressures in financial markets will remain very strong. Large public sector borrowing requirements resulting from a substantial Federal deficit put upward pressures on interest rates for private borrowers—including small businesses. I believe it is critical, therefore, that the Congress and the administration work to reduce the Federal deficit promptly and substantially. Combined with the Federal Reserve's monetary policy, this would minimize the strains on our economy and financial markets, and reduce the length of the adjustment process needed to bring inflation down and, with it, interest rates.

We at the Federal Reserve are acutely aware of the difficulties that have beset small businesses in recent years. At the same time, we think it is noteworthy that small businesses generally have been among the strongest and most steadfast supporters of the Federal Reserve's policy of moderating expansion of money and credit. This is because they recognize that such a course—however painful in the short run—is a necessary precondition to the overriding goal of returning our economy to a path of steady noninflationary growth. We are beginning to see some indications that inflationary pressures are now beginning to abate. It is vitally important that we avoid the temptation of opening up the monetary spigot to obtain temporary relief from high interest rates—relief that could only come at the expense of our longrun progress toward reducing inflation. Turning away from a disciplined monetary policy would be unsound, unwise, and unfair since it would mean that the difficulties already endured would have gained nothing, and that greater dislocations and more intense pain would necessarily be suffered at some point in the future.

Mr. Chairman, I would be happy to answer whatever questions there may be.

Senator WEICKER. Two questions that I would pose relate to those aspects of the administration's economic game plan that concern themselves, first with the tax cut and the size of the tax cut, and, second the failure to accord the same disciplines to the defense portion of the budget that was accorded other segments.

Would you like to comment on both those features of the plan?

Mr. SCHULTZ. Beginning in January of this year, I began making speeches. In the first half of the year I made about 50 speeches in which the bottom line was basically if the budget cuts are not deep enough, or if the tax cuts are too great, we will have some serious problems. I think we are seeing those problems today.

We have always believed that the budget deficit made a big difference. It makes a lot of difference in the supply-side arguments you may make, but it makes the biggest difference in the question of credit demands and the problems of the crowding out of the private sector by the public sector. Whether you solve that deficit problem by further budget cuts or by smaller tax cuts is a decision for the Congress of the United States and the administration to make. The only thing we can say is we believe, particularly in this period, that budget deficits are extremely important.

Whatever kind of esoteric economic arguments you wish to make, the basic fact is that most of the people in this country believe that budget deficits cause inflation. Unless we break those inflation expectations, inflation is not going to come down.

As far as the defense aspects of the deficit are concerned, Senator, I do not have the expertise to know what level of defense expenditures we need in this country.

I do know that the budget authority for defense expenditures has grown very rapidly in the last couple of years, perhaps on the order of 40 percent.

The only thing I would say to you is that historically, this country has won its wars because of its economic strength. I think national security depends very greatly on a strong economy, and our economy is not as strong as it could be at this point in time.

Senator WEICKER. Thank you very much.

Senator Nunn?

Senator Nunn. I have just a couple of very brief questions, Mr. Schultz.

Do you have any figures yourself about what it does to the overall budget deficit when the real growth rate goes down one percentage point?

Mr. SCHULTZ No, I do not, Senator. I have Mr. Don Kohn, the Deputy Associate Director of our research department, here with me. He was attempting to make some quick mental calculations. I think he would agree that it is certainly less than $50 billion, as Jordan stated, but I am not sure we can give you a better figure.

Mr. KOHN. It would be more on the order of $20 billion by the following fiscal year.

Senator NUNN. The figure I got from CBO is if it is one percentage point lower in 1982 it means an $8 billion increase in the the deficit the first year, 1982; cumulatively, $17 billion in 1983 and $33 billion in 1984. That is based on CBO assumptions.

Mr. SCHULTZ. I think that that sounds generally accurate.

Senator NUNN. I believe Mr. Volcker testified that we need to cut spending $100 billion over the next 3 years. Is that right?

Mr. SCHULTZ. I think he said up to $100 billion in fiscal year 1984.

Senator NUNN. What assumed growth rate is that testimony based on?

Mr. SCHULTZ. Less than the administration's figures.

Senator NUNN. If the growth rate came down 1 or 2 percentage points, it would not effect Mr. Volcker's testimony?

Mr. SCHULTZ. That is correct.

Senator NUNN. I think the administration is saying now that we need to cut about $90 billion over the next 3 years. I assume that they are basing that on their own growth rate assumptions. Would that be your assumption?

Mr. SCHULTZ. I have no way to answer that, Senator.

Senator NUNN. There is no need to pursue that. I was just going to say if the administration is basing their estimate of about $90 billion in cuts over the next 3 years on their own growth rate of 5.2 percent, and if growth rate is really a couple percentage points, less, which I think most economists believe it will be; then on the administration's figures, you would have to add another $66 billion in cuts, which would mean you would really be talking about $156 billion in cuts over the next 3 years. However, those are all based on CBO assumptions.

Last week I met with the manager of a bond trading operation of a Wall Street brokerage company. He told me the Federal Reserve had increased the level of reserves available to banks in 7 out of the last 8 weeks. He said these increases will show up in the money supply figures in November and December. Do you agree with this?

Mr. SCHULTZ. Not necessarily. Shortrun changes in the money supply are going to depend on a variety of factors such as the level of economic activity. As you know, what we have done is to set out longer run target ranges for the monetary aggregates. Then what we do is to compute the level of reserves that are needed to support those aggregate figures, and when the aggregates move one way or the other, then of course that tends to move the actual level of reserves. When those reserves move above or below the target ranges, then the Federal Reserve goes into the market to take action.

Senator D'Amato was talking about the action which was taken yesterday, which was actually a very small action and taken purely to drain some reserves because the reserves were slightly higher than the target.

Senator NUNN. Thank you.

Mr. Chairman, I took so much time with the previous witness, and I have talked with Mr. Schultz at length before, so I will waive the rest of my time.

Senator WEICKER. Thank you, Senator Nunn.

Senator D'Amato?

Senator D'AMATO. Mr. Schultz, could we pursue our talk about yesterday's actions. I have a copy of the Wall Street Journal here. It says: "The market jitters were intensified when the Federal Reserve drained reserves * * * by selling to dealers." Further, it goes on to say: "In the short-term market yesterday, interest rates surged. The latest 3-week Treasury bill closed at 14.45, up from the average return of 14.398."

Is that what you intended to do?

Mr. SCHULTZ. No, Senator. We do not have an interest rate target. We are not intending to set interest rates one way or the other.

Senator D'AMATO. However, Mr. Schultz, you say you do not have an interest rate target yet and you know full well what these actions will do. You knew this would take place, did you not?

Mr. SCHULTZ. No.

Senator D'AMATO. You mean the Federal Reserve Board does not see that when it goes and either sells or buys securities it has an effect on both the bond market and the interest rate?

Mr. SCHULTZ. However, sometimes you cannot predict what direction that is, Senator.

Senator D'AMATO. Well, I want to tell you something. If after all these years you cannot tell when you drain the moneys out of the banks and make them buy your securities that you are going to drain available credit and force up interest rates, then something is wrong.

Mr. SCHULTZ. Senator, I think that is not correct.

Senator D'AMATO. Former Treasury Secretary Simon said to me he can tell every time, and that is how a living is made in the bond market. They watch and see what you do.

Mr. SCHULTZ. I am happy that former Treasury Secretary Simon knows how to do it every time. I do not know of anybody else in the world who does.

Senator D'AMATO. He does it pretty successfully.

Mr. SCHULTZ. He has indeed been very successful, but the idea that you can tell from 1 day's actions of the Federal Reserve which direction interest rates are going to go is an inaccurate one. That is just not the case.

Senator D'AMATO. You say that the Federal Reserve Board has no motivation in terms of controlling interest rates by this fiscal manipulation, as I choose to call it?

Mr. SCHULTZ. That is correct. We do not have an interest rate target, Senator. What we have is a target for controlling the quantity of money.

Senator D'AMATO. However, you know it has an effect on the interest rate.

Mr. SCHULTZ. Senator, we injected reserves in July and August to a vastly greater extent than the small draining operation yesterday that you are talking about. The markets are very volatile.

What you are not saying is that those markets surged tremendously over the last week. Prices increased very rapidly over the last week. The very fact that a small draining operation by the Federal Reserve should cause the kind of a drop that it did yesterday in my mind shows clearly that this was a technical response of the market, because the small amount of reserve draining should not by itself cause it.

Senator D'AMATO. Mr. Schultz, let me ask you this: Do you keep any records that indicate what response interest rates have in terms of the technical moves, your purchasing and your sales? Do you have figures that would indicate that? You must have them. Your economists must compile them, do they not?

Mr. SCHULTZ. Figures that would indicate what, Senator?

Senator D'AMATO. Whether the interest rates move up or down corresponding to your going into the market either to sell or purchase securities.

Mr. SCHULTZ. Oh, yes, we have them with a lot of detail.

Senator D'AMATO. I do not want the kind of detail in 50 pages that would make it impossible for us to comprehend. What I want to know is if it is tied to interest rates, whether they go up or whether they go down, when you go into the market and sell or buy securities. You see, I contend that you know the likely impact when that if you do this.

Mr. SCHULTZ. Senator, that is not correct. It will vary depending on a variety of factors.

Senator D'AMATO. I am sure that is accurate.

Mr. **Schultz**. If we are engaging in some continuous draining of reserves, that will have the effect, but what you are asking me is a 1-day question. The 1-day effect varies. It depends on what kind of general policy is being carried out.

The reason for that drop yesterday is purely, in my opinion, an expectation. The markets had had a big surge in the last week. They did not know how many reserves the Federal Reserve would be willing to supply. They see the Federal funds rates drop to 14.5 percent. They wonder what level we are willing to tolerate. They see that we at some point begin to drain reserves. They have a quick technical reaction.

They have to react quickly in today's world because they cannot stand the cost of carrying. Bond traders cannot keep very many bonds in inventory because it costs them too much. They have to make quick swings. What they have done in the last week or so is to build up some inventory because the market was improving. If they see that there is any indication that that market might not continue to improve, they would not want to carry that inventory. One day's action of the Federal Reserve is just not going to make that much difference, particularly when it is as small as it was yesterday. It was a much smaller reserve draining than we do on a normal day.

Senator **D'Amato**. There are those who indicate and characterize the Federal Reserve coming into the market, as it does in many cases, as fiscal manipulation or monetary manipulation. You have heard that charge. You have heard the statement made.

I begin to share their viewpoint. Although you talk about controlling the money supply, in fact your actions have an absolute impact, a direct correlationship affecting the direction of interest rates. You control whether they go up or whether they go down and by how much.

Mr. **Schultz**. They have some effect on quick movements, but in the long run, it is inflation that affects the interest rates.

Senator **D'Amato**. Let us move on to one other thing before I pass this over to my colleagues.

The Federal Reserve was charging a 4-percent surcharge at the discount window. There was some talk about your dropping that or eliminating it. You dropped it to 3 percent.

What would be the effect of dropping the 3 percent even further, reducing it to 2 percent or totally eliminating it? What effect, if any, would that have on interest rates?

Mr. **Schultz**. We think that the effect might be to make them go up. The surcharge does not have a very great effect on borrowing because there is not very much borrowing at that rate. Therefore, the actual direct economic effects of it are not very great.

What it does have an effect on is expectations. If the market were to see that the Federal Reserve had dropped an additional one or even two points, or eliminated it, it is our belief that they would then think that we had in fact caved in, which is what they continue to look for us to do.

Rhetoric does not help much in today's world, Senator. For 15 years, people in this country were told we were going to get inflation under control. We never did it. Now they do not believe we are going to do it. They believe that things are going to get tough enough that the Federal Reserve is going to cave in and pump up the money supply, and that we are going to have worse inflation and that interest rates are going to be much higher than they are today. That is where the 15 and 30 percent estimates of interest rates really come from. It is that expectational factor.

We think that the surcharge is more a signal at this point than anything else. We think too big a drop in that surcharge rate would be a signal that we have given up the fight on inflation, and we think the markets would respond in just the opposite way, and that interest rates would in fact rise.

Senator D'AMATO [acting chairman]. Thank you very much.

Senator Huddleston?

Senator HUDDLESTON. Mr. Schultz, let me ask you, too, has the Federal Reserve calculated, or what is your estimate of the number of small businesses that have to be put out of business before the administration's economic plan works?

Mr. SCHULTZ. No; we would have no way to make such a calculation, Senator. I think it is pretty clear that we have some tough times in this country right now. I think it is pretty clear that there is a good deal of pressure on small businesses. How much is hard for me to estimate.

Senator HUDDLESTON. Let me suggest that you go out and walk down main street in some small town. They will give you a good estimate.

Mr. SCHULTZ. I do better than that, Senator. We make many telephone calls every week to small banks and to small businesses. We collect enormous amounts of quantitative data, but to get some qualitative information we also try to find out just exactly who is in a lot of trouble, and we make an awful lot of telephone calls to try to get that information. It is interesting. We get mixed responses. There are a lot of banks, for instance, that have special programs to lend to small businesses.

Senator HUDDLESTON. I think you ought to quit talking to so many banks and start talking to some businesses.

Mr. SCHULTZ. Senator, that is exactly what we try to do. My background is from business. I take calls from businesses every single day. I meet with different groups that come in to see us. I do not think a week goes by that I do not meet with someone from the homebuilding industry. That is one area that is getting hurt the worst.

Senator HUDDLESTON. Do you dispute their figures on the numbers who are going out of business?

Mr. SCHULTZ. Absolutely not. We not only do not dispute them, we collect information from them.

Senator HUDDLESTON. Do you dispute the automobile industry's figures?

Mr. SCHULTZ. No; they are quite accurate. As a matter of fact——

Senator HUDDLESTON. Where are we leading then? What is the final figure? How far do we go on this track?

Mr. SCHULTZ. Senator, we have a tough period here. There are going to have to be some hard decisions made. Are we going to stop inflation in this country now, or are we going to let it go?

It is my opinion that if we let it go from here, the situation in this country is going to be absolutely disastrous.

Senator **HUDDLESTON**. I understand that, but I would be interested to know——

Mr. **SCHULTZ**. If we backed off from our commitment to fignt inflation the failure rate could rise to 1,000 per 10,000 firms rather than 50 as it is now.

Senator **HUDDLESTON**. However, if we are going to assess the relative merits of the objectives, we ought to know how many small businesses we are going to put out of business to stop inflation. What is your plan?

Mr. **SCHULTZ**. Senator, there is absolutely no way to know the answer to that question. That is a total impossibility. What I can tell you is——

Senator **HUDDLESTON**. It has to be a lot of them, does it not?

Mr. **SCHULTZ**. I think clearly there will be. The qualitative information we get is that there are a lot of small businesses in trouble out there. However, I made the same kind of prediction a year ago that small business would be under some real pressure as we tried to get inflation down, and if we did not have the right kinds of programs, we would see a lot of bankruptcies.

I will tell you that that level of bankruptcies among small business is much lower than I would have expected a year ago. It is amazing to me how well the small businesses have adapted. They have learned how to fight.

Senator **HUDDLESTON**. They are up 42 percent. What did you expect them to be up to?

Mr. **SCHULTZ**. I would have expected something greater.

Senator **HUDDLESTON**. In other words, the plan is to eliminate a certain number. We do not know what the number is yet, but we know we have to——

Mr. **SCHULTZ**. No, Senator, absolutely not. That is not true.

Senator **HUDDLESTON**. That is what you are telling me.

Mr. **SCHULTZ**. It is nobody's plan to put anybody out of business. Senator, I get telephone calls. Let me tell you, it is not so hard when I get a call from a guy saying, "You dirty so-and-so. I am going to get you." What is hard is when I take a call from a fellow who says in a very quiet voice, "I want you to know that I have been in business 35 years, and next week I am going to file bankruptcy."

I used to be in the venture capital business. I have dealt with small businesses for a very long time. I know what people go through to start and run a small business. I assure you that nobody wants anybody to go out of business.

The problem is we have gotten ourselves in a very tough situation. I know of no way to get out of it except——

Senator **HUDDLESTON**. You are saying you do not want anybody specifically. You are not going to walk up to a man and say, "I want you to go out of business." However, what you are saying is that our policies dictate, demand, and require that large numbers go out of business. There is no other way it will work. Is that right?

Mr. **SCHULTZ**. I think one of the problems of this administration was that it gave people the idea that there was an easy way out of this situation that we are in. I do not think there is an easy way out. There never has been. There is no way you can get inflation down without having some restraint on the economy.

The problem though is this: What can you do to get out of this situation? I know of no way to get out of a highly inflationary environment without some policy of monetary restraint. All I would hope is that that monetary restraint get some help on the fiscal side so that it is as painless as possible, but it is going to be painful under the best of circumstances.

Senator **Huddleston**. You do not think there is any way to lower the general business activity across the board so that many more can stay in business at a lower rate of business activity? There is no way to accomplish that? The only way to solve this problem is to just have a massive exodus from the building industry, the automobile industry, the savings and loan industry? You have to eliminate these almost entirely? Can you not spread this thing out a little bit?

Mr. **Schultz**. Yes, indeed, you can, Senator.

Senator **Huddleston**. Then why do we not try to do that?

Mr. **Schultz**. However, the way you have to do that is you have to reduce the deficit. That is what you have to do because monetary policy is a blunt instrument.

Senator **Huddleston**. Why does the deficit not hurt the big man a little bit?

Mr. **Schultz**. It does hurt. There are some big companies out there that are hanging right on the edge. I had the chairman of one of the largest businesses in the United States in to see me yesterday to tell me what difficult straits he was in. He happens to be in a business that feeds into the building industry. That is his difficulty.

Monetary policy is a blunt instrument.

Senator **Huddleston**. In my county, we have——

Mr. **Schultz**. May I finish this please, Senator?

Senator **Huddleston**. Yes.

Mr. **Schultz**. Monetary policy is a blunt instrument. It falls heavily on interest sensitive sectors. It is hurting homebuilding, automobile dealers, small businesses, farmers, the thrift industry, and municipalities, but energy, defense, high technology, data processing, and telecommunications appear to be doing well. I do not think relying so heavily on monetary policy is the best way to reduce inflation.

You asked me what is the best way to do it. The best way to do it is not to put so much pressure and so much weight on monetary policy but to have a more balanced policy, by which I mean to lowering the credit demands of the Government so that the private sector can have a better opportunity to get to those credit markets.

Senator **Huddleston**. That makes sense.

The administration told us that if the President got his economic package passed, interest rates would come down. We have not seen that happen. He got virtually what he asked for. We continue to reassess, reevaluate, and review the assumptions. They are moving targets all the time.

We have developed a tax system that is designed to direct capital into certain areas. Why can we not have an interest rate system that would be designed to try to at least give some kind of a safety net, a minimal safety net, to businesses that have no hope. There is no way they can survive. The plan is that they have to go. We have to sacrifice a certain number of businesses.

In my county, one of the most prosperous counties in the State of Kentucky with a good agriculture base, we had at the beginning of the year four farm implement dealers. Some of them had been in business 50 years, for three generations. Out of the four, three are totally out of business at the present time. The fourth one is hanging on. He thinks he might make it until the end of the year, but it is very doubtful. This is not an isolated situation as you know.

My question is: How many? What is the figure that must be put out of business in order to convince you folks?

Mr. SCHULTZ. You are on the wrong track, Senator. There just is not any number like that.

Senator HUDDLESTON. We have to look at that track because every one that goes out of business has a corresponding effect on the success of eliminating the deficit because it affects the revenue of the country and it affects the expenditure of the country. If you have not figured out where the balance is, then this plan does not have any possibility of working.

Mr. SCHULTZ. I disagree with that. I do not think there is any possibility of doing what you suggest. What I am suggesting to you is that the next 6 to 9 months are going to be very, very tough.

Senator HUDDLESTON. What you are saying is that *x* number of people are going out of business.

Mr. SCHULTZ. I think there will be some additional people who are going to go out of business. You can help that, Senator, if you can do something about that budget deficit. You can help a lot.

Senator HUDDLESTON. We are working on that, but I do not think that is going to save my farm implement dealers. If you would figure out how many people it is you have to put out of business, you ought to circulate it and we might get enough volunteers to go on out.

Mr. SCHULTZ. That is a very attractive way to say it, except it really does not make very much sense because we have no idea how many people have to be put out of business.

Senator HUDDLESTON. A large number.

Mr. SCHULTZ. Clearly there are. It is a very unpleasant situation. You are talking about farm implement dealers, and you are talking about one of the areas that is getting hurt the worst. It is a very serious situation.

How do we get through this period in the least painful way? I think that is what we have to face. If we give up on inflation—which, Senator, I am not willing to do because I have four kids and I want them to have the opportunity to live in the same kind of country that I grew up in—I am convinced the result will be a different country with not only a different economy but a different quality as well.

We have a tough period to go through. Let us try to do it the least painful way we can. I think that requires some real help on the fiscal side.

Senator HUDDLESTON. Thank you.

Senator D'AMATO. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Schultz, most everyone agrees that if the deficit is lowered, it will help reduce inflation expectations as well as help lower interest rates. From the Federal Reserve's point of view, does it make much difference whether we lower the deficit by using spending or whether we in Congress along with the administration help lower the deficit in future years by rolling back the tax cut or introducing some kind of tax bill which increases revenue?

Mr. SCHULTZ. From a purely economic point of view, I think the answer is no, Senator. However, you may have some other important concerns about what percentage the public sector is going to be and what percentage the private sector is going to be.

Senator BAUCUS. From the Federal Reserve's point of view, would you recommend one course over the other?

Mr. SCHULTZ. No, I do not think we would be in a position to do that, Senator. I think that is a matter of individual philosophy. Mine happens to be that the economy works better when the percentage of GNP that the public sector takes is not as high. I think my personal philosophy would be to advocate further spending cuts.

However, you did not ask me that question. You asked me whether economically it made much difference. My answer to that is no.

Senator BAUCUS. Economically from what point of view?

Mr. SCHULTZ. I think the critical point is the deficit. You may argue that later on the question of how big the public sector is makes a lot of difference, and that you ought to lower the percentage that the public sector is taking of GNP, but the critical point now, I think, is to get control of the budget deficit and the credit demands of the Government and to bring these down over time to achieve a balanced budget in a reasonably prosperous economy.

Senator BAUCUS. To what degree is that also because from a psychological point of view people think the cuts cause inflation? I am looking at people's expectations. I tend to believe that regardless of the economic analysis, people psychologically think that the Federal deficit causes inflation.

Mr. SCHULTZ. I do not think there is any question about that.

Senator BAUCUS. Therefore, people psychologically decide to spend now rather than later and act according to strong inflation expectations.

Mr. SCHULTZ. I think that is absolutely right.

Senator BAUCUS. You are suggesting that regardless of the economic analysis of the effect of deficits on inflation, there is a very strong psychological factor that alone is almost sufficient reason to lower the deficit.

Mr. SCHULTZ. I think the expectational factor is extremely important at this point in time. We have been talking about the bond markets. If people felt that we really were going to get inflation under control, the only sensible thing to do would be to go out and beg, borrow, and steal every dime possible and invest it in the bond market. It has to be the best buy that anybody has ever seen for those who think inflation is going to come down. That this is not happening is a clear indication that those expectations have not been broken. Until they are, lenders will not be willing to lend at lower rates of interest because right now they say they do not believe inflation is going to get under control. They have been burned before.

You must remember that nobody out there is under any pressure to be a hero at this point in time. I know of no investment manager that is under any pressure from his clients to put money in the bond market. The pressure is in the other direction. Investors are saying they have been hurt enough with the bonds. They do not want any of them. Until they know that interest rates are going to come down, they do not want to buy fixed income securities.

Therefore, the long-term capital markets are not working well. Credit demands get focused on the banks. Until those expectations are broken, there are likely to be problems with the capital markets.

Senator NUNN. Senator Baucus, would you yield for just one question?

Senator BAUCUS. Certainly.

Senator NUNN. Mr. Schultz, do you believe that the tax cuts went too far?

Mr. SCHULTZ. In view of the budget cuts that were made, I think the answer to that is "Yes." I think the market said so. When you were involved in those budget cuts, the market was improving. When the tax cut bill was introduced, there began to be market problems which worsened the bigger that tax cut got.

Senator NUNN. Would you yield for one other question?

Senator BAUCUS. Yes.

Senator NUNN. Do you believe that if we put contingencies based on reductions in Federal spending in front of the 1983 and 1984 individual tax cuts it would have any effect on interest rates? In other words, the tax cuts would go into effect in proportion to a certain reduction in Federal spending, but would not go into effect if those reductions were not made.

Mr. SCHULTZ. I believe that anything you do which gives the market a credible program of reducing those deficits will have a big effect. As I say, you can do that in one of two ways. You can either further cut expenditures, or you can do something about raising or delaying on the revenue side.

Senator NUNN. Would that hypothetical not have that effect if you were to say that the 1983 and 1984 individual tax cuts would not go into effect except in proportion to certain spending cuts that would take place? If they did not take place, the tax cuts would not take effect and you would not have the revenue loss.

Mr. SCHULTZ. My judgment is that that would be helpful, as would other things which have the effect of cutting that deficit. Senator, I am not in a position to be able to give you any good information on which way you ought to go, cutting the budget further or doing something about the tax cuts. I think that is a decision you have to make.

However, anything that you do that will help to hold down that deficit, that will give the market some real belief that something has been put in place to lower that deficit and balance it over time, and not just words, would, in my opinion, be helpful.

Senator NUNN. Thank you.

Senator **BAUCUS**. Thank you, Senator Nunn. I was going to ask the same kinds of questions.

To pursue that a little further, what if Congress were to enact a similar provision so that tax cuts would not go into effect because the spending cuts are not as great as some would like? You are suggesting that that would have a beneficial effect on the financial markets and expectations because the deficit would be lowered.

What about those who say that if there is not a tax cut, there is less revenue for investment and the capital markets will decline? What offsetting problems would there be if the tax cut does not go through?

Mr. **SCHULTZ**. The whole supplyside theory depends very heavily on savings.

Senator **BAUCUS**. Right.

Mr. **SCHULTZ**. If you are going to produce more, you have to have investment, which means you have to have savings. People are not going to save more unless you make it more attractive for them to save. In that regard there is one good aspect of high interest rates. It makes people want to save more, but certainly that is overpowered by all the other bad aspects of high rates.

However, I think what will be most attractive to people in terms of saving is the feeling that we are going to get inflation under control—that the Federal Reserve is going to continue with its policy of bringing down the money growth over time, and that we are going to balance the budget. Under those circumstances, people will want to save more.

Have you been to any group meeting recently and heard anybody say, "I think I will not buy that now because it will cost less next year?" I have not heard anybody say that yet.

Senator **BAUCUS**. You are saying any reduction in the company's plans to ignore capital assets because of reduced incentives will be offset by people's positive expectations about lowered inflation and therefore incentives to save.

Mr. **SCHULTZ**. Insofar as a company's decisions are made——

Senator **BAUCUS**. Which is not supply-side economics.

Mr. **SCHULTZ**. That is right. I think a company's decisions to invest will be helped by accelerated depreciation, but, in my opinion, what will help them more than anything else is the idea that inflation is going to come down.

Inflation really holds back investment in a lot of different ways. For example, it makes the threshold rate of return much higher, and the cost of funds higher. If businesses have an idea that inflation is coming down, that is quite a stimulus.

Senator **BAUCUS**. We do not have the time to go into this, but in a nutshell, just several sentences only, I am curious as to what you think the cause of inflation really is. It seems to me that in a large degree we in Congress should be attacking the cause of inflation along with the symptoms. In fact, we should be spending more time attacking the causes rather than the symptoms of inflation.

It is one thing to enact usury laws to set limits on interest rates. Frankly, I think that is shortsighted. I would rather spend our time trying to find the basic causes of the problems we are facing.

I am curious as to the degree to which you think it is just excessive Government spending in the future that is the cause of inflation, or if it is OPEC energy price increases which are responsible? I know it is a long involved subject and everybody has their view of it, but I am curious as to your point of view. Are there some other causes of inflation, other than Government spending per se, that we in the Congress should be focusing on so that we can spend our time appropriately attacking causes rather than the symptoms?

Mr. SCHULTZ. I think there are a lot of causes to inflation, but I think Senator Tsongas gave you your real answer: "We have met the enemy and they are us." By and large, I think the biggest cause of inflation in this country is excessive Government spending, especially when the Government deficits are monetized by the Federal Reserve.

Senator BAUCUS. You think people, as reflected through Congress, just ask too much for themselves?

Mr. SCHULTZ. We pumped out too many dollars for the number of goods that were available in the country. Therefore, the price level has gone up.

Senator BAUCUS. You do not think that OPEC had much to do with it?

Mr. SCHULTZ. Certainly it makes some difference, but I think by far the biggest impact comes from Government spending and excessive creation of money and credit.

Senator BAUCUS. Would you have any objection if the open market committee or the Federal Reserve Board were required to have a farmer or a small businessman on it, somebody to give a little balance and a different perspective to the decisions of the Board or the open market committee?

Mr. SCHULTZ. In my opinion, it is a good idea for the Federal Reserve Board to have a broad balance. My term runs out the last day of January. I think it is vital that whoever replaces me has broad business and financial experience, some experience in the nitty-gritty of day-to-day business activity.

Given the kind of changes that are taking place in the financial structure, I think it would be wise if that person had some experience in commercial banking and in terms of how the financial structure works. However, I think that the Federal Reserve Board ought to have a balance. I do not think it is very wise to do that by legislative fiat, by saying that unless you have a particular criteria, you should not be on the Board.

Setting monetary policy is a very complex problem and a very complex mechanism. That is of course one of the reasons that Congress has created a Federal Reserve, so that it supposedly can carry out that process with some degree of expertise. I think it is well if you have people who have some degree of expertise, but I think it is also important that there be at least one member of the Board with broad business and financial experience.

Senator BAUCUS. My understanding is that of the seven members of the Board, six are economists. I just wonder if it might not make more sense to have a little better balance.

Mr. SCHULTZ. I think you are correct. I believe all seven members should not be professional economists. My feeling is that the qualifications of the Vice Chairman should be broad financial and business experience, hopefully some experience with the financial structure of the country, and, I think, some managerial experience as well. There are 1,500 people at the Board. I think how they are managed makes some difference to the work product.

Senator **Baucus**. I understand the Board makes a lot of calls to and receives a lot of calls from businesses around the country. However, do you have the opportunity to get out of the East and get in a car, drive out in the countryside, walk up and down main street, go to a little cafe, and talk to farmers and people in really small businesses so that you get a firsthand impression?

Mr. **Schultz**. Not as much as I would like to. I try to do that upon occasion, but it is rare. One of the ways I try to overcome that is by going out and giving talks to a lot of different groups. A number of different groups come into the Federal Reserve. I talk to them and question them to try to get that kind of feeling you are talking about.

I was in the State Legislature of Florida during the 1960's. I was speaker of the house. I recognize how important it can be to go out and find out these things firsthand.

More and more, we are trying to have other people in the system do that. There are community affairs officers at the Reserve banks who are doing that. Our bank presidents are doing that. The district banks are reporting to us. I think Mr. Corrigan from your district is doing a very good job of getting out and trying to get that kind of hands-on feeling that you are suggesting we ought to have.

Senator **Baucus**. I suggest you do that. I was impressed when I found that an ambassador from a foreign country, one of the major larger foreign countries, takes a month out the year and just travels around America unannounced. In talking to him, I could tell that has had a very direct effect on his perception of America.

Mr. **Schultz**. I think Alexis de Toqueville found that rather valuable, too, but I am not sure that all of us have that opportunity or that degree of perception.

Senator **Baucus**. It is a question of priorities. You can make it if you want to.

Thank you very much.

Senator **D'Amato**. Mr. Schultz, we thank you for your testimony here today. I would like you to followup in checking out some of those figures.

Mr. **Schultz**. Senator, we will see if we can get you some figures on the question you asked: What kind of day-to-day movements are there when the Federal Reserve goes into the market? I will see if I can get some figures on that.

Senator **D'Amato**. Thank you very much.

[Subsequent information and the prepared statement of Mr. Schultz follow:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

October 1, 1981

FREDERICK H. SCHULTZ
VICE CHAIRMAN

The Honorable Alfonse D'Amato
Room 432
Russell Senate Office Building
Washington, D.C. 20510

Dear Senator D'Amato:

I am writing to follow up our discussion of the effect of Federal Reserve open market operations on interest rates at the hearings of the Senate Committee on Small Business on Wednesday, September 23.

It is our experience that specific open market operations generally have little effect on interest rates. Their size, timing, and direction depend on reserve paths set to attain monetary targets and on other factors affecting reserves. Open market operations and interest rate movements must be interpreted in light of underlying supply and demand forces determining credit conditions.

Interest rate movements are related to a large number of forces that affect the supply and demand for money and credit. Expectations are a critical influence on rates, and affect both borrowers and lenders. The actual pressure of demand on markets varies with current credit needs, including those of federal government, as well as expectations. Demand pressures can vary with changes in spending or with an increased or decreased willingness to use credit or to hold money in relation to a given level of spending. On the supply side the amount of saving available to credit markets as a whole, or to particular market sectors, depends on the many economic and psychological influences on the public's propensity to restrain consumption and place funds in financial assets. Federal Reserve operations in this context should be viewed as influencing the supply of money and credit through efforts to control reserves of the depository system and to attain announced money supply targets. As such, they are only one of the many forces of supply and demand whose interplay determines interest rates.

Over short-run operating periods of several weeks, the Federal Reserve determines a growth path for reserves consistent with its targets for monetary expansion and engages in open market operations to maintain the supply of reserves on this path. However, there are a wide variety of factors other than Federal Reserve open market operations that affect the volume of reserves in the banking system. Among the most important of these are the size of the Treasury's balance at the Federal Reserve, the volume of currency held by the public, and the leads and lags of the check collection process. These factors can vary substantially from week to week, and a high proportion of Federal Reserve open market operations are undertaken simply to prevent such shifts from having undesired effects on reserves, and through that on money and interest rates. A large voldme of Federal Reserve operations also are done to prevent seasonal variations in the demand for money and credit from producing seasonal waves of ease and tightness in financial markets.

Thus most System operations are keyed to preventing temporary or extraneous factors from causing the expansion of bank reserves to deviate from the path consistent with achieving the Federal Reserve's monetary targets. If these targets exceed the volume of money the public desires to hold at existing rate levels, then short-term interest rates will tend to decline as reserves are provided to support money growth; movement in the opposite direction will tend to occur if the System's targets fall short of public demands. However, there is rarely a significant market reaction to individual Federal Reserve security transactions, because most market participants understand that they are primarily undertaken to offset transitory influences on reserve availability.

I appreciate this opportunity to expand on my remarks, and I hope you have found this discussion useful.

Sincerely,

Frederick H. Schultz
Vice Chairman

For release on delivery
Expected at 9:30 A.M. EDT
September 23, 1981

STATEMENT

BY

FREDERICK H. SCHULTZ, VICE CHAIRMAN

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BEFORE THE

SENATE COMMITTEE ON SMALL BUSINESS

SEPTEMBER 23, 1981

I appreciate the opportunity to participate in this hearing on the impact of high interest rates on small business. Driven principally by rapid and persistent inflation, interest rates have been at extraordinarily high levels through much of the past several years, causing serious problems for many sectors of the economy.

Because small businesses account for the vast majority of the firms in this country today, and operate in all areas of the economy--in both a geographic and business sense--it is not surprising that they are feeling the effects of the high rates. Moreover, there are some reasons to believe that small businesses may be more vulnerable to the adverse consequences of credit stringency than are larger firms. Recently, Chairman Volcker sent a report on the impact of high interest rates on small business as well as on the auto, housing, and agricultural sectors to the Senate Committee on Banking. I have submitted that report with my statement and, as a basis for discussion at this hearing, I would like to highlight and elaborate on some of the major points made in it concerning small businesses.

1. Small businesses typically depend relatively more on debt financing than larger firms since their sources of equity capital are more limited. As a result, small businesses tend to have higher ratios of debt to equity, and the interest on the debt of small firms likely absorbs a relatively larger portion of cash flow than for similarly situated larger firms. The squeeze on cash flows of smaller firms can be especially intense if competitive pressures and sluggish demand prevent them from passing along the full cost of higher interest rates to their customers.

2. Small businesses tend to rely on commercial banks to meet their credit needs. This suggests that the impact of high interest rates on this sector depends to a great extent on the cost and availability of loans at banks and on the relationships between small businesses and their banks.

3. Direct information on the terms of bank loans made to different size businesses is not available, but data from the Federal Reserve Board's Survey of Terms of Bank Lending show that rates on small loans have risen less than those on large loans over the past several years. Moreover, in recent surveys, the average levels of rates on small loans at small banks, the type usually going to small businesses, have been generally about the same or even lower than the rates charged on larger loans at large banks. Of course, these data do not reflect the ability of large businesses to reduce borrowing costs by accessing other markets, where rates at times may be more attractive.

4. Problems of credit availability do not appear to have worsened markedly for small business this year. This is in contrast to earlier periods of high interest rates, when lending at banks--especially small banks--was severely constrained by difficulties they faced in attracting funds because of limitations on interest rates they could pay on deposits. In these circumstances many small businesses encountered trouble obtaining credit at any price. More recently, with restraints on the rates banks can pay somewhat more relaxed, most small businesses have access to credit, if they are willing to pay the price. In addition, a number of banks throughout the country reportedly have been making special efforts to be more flexible in meeting the needs of small businesses, a practice which the Federal Reserve System has consistently encouraged.

5. Although I am confident that our assessment of the current status of bank lending to small businesses is reasonably accurate in broad outline, we are aware of our lack of more detailed knowledge of this crucial relationship. In that regard, the Board, in conjunction with the interagency task force on small business finance, is currently in the process of conducting a personal interview survey with lending officers at 250 banks throughout the

country on commercial bank small-business lending practices. The interviews include questions on availability of credit to small businesses, loan characteristics, pricing and profitability, and use of government programs. The information gathered from the interviews will give us further insight into the effects of current credit conditions on small business. A report on the results will be sent to the Congress in early 1982.

6. Finally, I am encouraged by reports that many firms are learning to cope with the adverse financial and economic environment through such means as improving their product pricing strategies, cutting costs, reducing inventories, and managing cash more closely. Nonetheless, the large increase in bankruptcy filings since early 1980 is an indication of the difficulties being experienced by a number of small businesses. Of course, the bankruptcy numbers reflect not only problems related to high interest rates, but also those related directly to inflation and sluggish economic activity, as well as the liberalization in the bankruptcy code effective October 1979.

In sum, small businesses, along with larger businesses, households, and many lenders, are facing a very trying situation, the proximate cause of which seems in large measure to be high interest rates and intense competition in the credit markets for a limited supply of funds.

Moreover, many have asserted that this situation can only be worsened by the recent surge of bank lending activity associated with mergers among some very large firms. The loans and commitments involved are extremely large, and some have concluded that funds advanced for this purpose will not be available for any other use--such as for lending to smaller businesses.

In my view, any effects from this activity are easily exaggerated. First, the volume of credit involved is not that large relative to total flows; the actual amout of loans taken down for takeover purposes appears to be much less than the reported credit lines, in part becasue a number of the lines were related to the proposed takeover of the same company. Second, and more importantly, these loans and the transactions they finance do not in any fundamental sense use credit in such a way as to make it unavailable to other borrowers. The actual transactions involved in the mergers merely result in a transfer of financial assets; the acquiring company borrows money from the bank to pay the stockholders of the acquired company. The stockholders then likely reinvest the money or repay debt, recycling the funds through the financial markets. I recognize that in the short run these loans could have some impact on the distribution of credit, possibly affecting its cost and availability for other bank customers. But I believe that in a freely operating financial system any distortions of this sort are likely to be small and short-lived.

The problems facing small businesses are not related to takeover lending; they are not even caused in the most fundamental sense by high interest rates. Rather, the principal source of their current difficulties is the extraordinarily high and persistent level of inflation our country has experienced in recent years. Inflation has a very direct and immediate effect on the entire cost structure of industry. Increases in labor and other input costs likely have a much greater impact on the earnings of small businesses than do rising interest rates. Recognizing this fact, small businesses until very recently have identified inflation, not credit costs, as their principal problem.

Moreover, high interest rates themselves are primarily a necessary and unavoidable consequence of rapid inflation, augmented under current circumstances by anticipation of large federal deficits. Only in recent months have price increases shown significant moderation from the double-digit rates experienced in the last two years. The virulence of actual inflation and expectations that it will continue at a high rate have prompted lenders to demand interest rates high enough to compensate for the declining purchasing power of the dollars they lend. Expectations of price increases also weaken borrowers' reluctance to pay high interest rates. The impetus needed for a significant and lasting decline in interest rates is a continuing slowdown in the actual rate of inflation and a conviction by both borrowers and lenders that those making monetary and budget policy will not allow the rate of price increase to reaccelerate.

Because of the problems inflation has brought to our economy, it is imperative that the government implement policies that focus on bringing the inflation rate down--and keeping it down. For its part the Federal Reserve has been seeking a gradual moderation over the longer run in the growth of the money supply. As this policy bears fruit, we are confident that the result will be reduced pressures in the credit markets and an eventual decline in interest rates.

We realize that the adjustments required will be painful; we should not expect the reversal of a 15 year trend of accelerating inflation to be accomplished quickly and without unpleasant side effects. The process of adjustment to a noninflationary environment can be made less painful, however, if the Congress and the Administration hold down federal government spending. The tax cuts that already have been legislated need to be balanced by additional expenditure cuts. If further spending cuts are not made, pressures in financial markets will remain very strong. Large public sector borrowing requirements resulting from a substantial federal deficit put upward pressures on interest rates for private borrowers--including small businesses. I believe it is critical, therefore, that the Congress and the Administration work to reduce the federal deficit promptly and substantially. Combined with the Federal Reserve's monetary policy, this would minimize the strains on our economy and financial markets, and reduce the length of the adjustment process needed to bring down inflation and, with it, interest rates.

We at the Federal Reserve are acutely aware of the difficulties that have beset small businesses in recent years. At the same time, we think it is noteworthy that small businesses generally have been among the strongest and most steadfast supporters of the Federal Reserve's policy of moderating expansion of money and credit. This is because they recognize that such a course--however painful in the short run--is a necessary precondition to the overriding goal of returning our economy to a path of steady noninflationary growth. We are beginning to see some indications that inflationary pressures are now beginning to abate. It is vitally important that we avoid the temptation of opening up the monetary spigot to obtain temporary relief from high interest rates--relief that could come only at the expense of our long-run progress toward reducing inflation. Turning away from a disciplined monetary policy would be unsound, unwise, and unfair since it would mean that the difficulties already endured would have gained nothing, and that greater dislocations and more intense pain would necessarily be suffered at some point in the future.

September 1, 1981

THE IMPACT OF HIGH INTEREST RATES ON THE HOUSING, AUTOMOBILE, AGRICULTURE, AND SMALL BUSINESS SECTORS

A Study by the Staff of the Board of Governors
of the Federal Reserve System

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THE IMPACT OF HIGH INTEREST RATES ON THE HOUSING, AUTOMOBILE, AGRICULTURE, AND SMALL BUSINESS SECTORS

I. Background

In response to a Congressional request, the Board staff prepared the following study on the impact of high interest rates on four sectors of the economy: housing, automobile, agriculture, and small business. Given the time constraints, the study was prepared with information from already available sources.

There are distinct limitations in the precision with which the impacts of high interest rates on the named sectors can be pinned down quantitatively. These limitations are the result partly of the normal difficulties in sorting out causal influences in a complex economy; they also are related to the paucity of hard data pertaining to some areas of activity, especially small businesses. Moreover, there is the more fundamental question of distinguishing in the performance of these sectors between the direct effects of high borrowing costs and the effects of the general sluggishness of growth in real income and output over the past two years--a development that can be related to a complex of factors, including the interaction of strong inflationary pressures and monetary restraint. Within the practical constraints imposed by these problems, an effort has been made to assess the dimensions of the difficulties encountered by the four selected sectors and the role of high interest rates in those developments.

II. Summary and Conclusions

(1) It is clear that homebuilding, auto, and agricultural industries have fared poorly during the past year or two. The pace of housing starts has fallen by more than half from the cyclical peak rate of 1979; domestic auto sales have declined a third from the 1979 pace; and net farm sector income has fallen 40 percent, in real terms, since 1979. It is less clear that the performance of small businesses as a group has been disproportionately bad during this period when the economy as a whole has recorded rather small gains in real output on balance; there are no aggregate data upon which to base a firm judgment. However, the small business sector cuts across industrial categories; in some lines of business small enterprises likely have prospered (for example, in growth industries such as energy and advanced technology), while in others (including the three already mentioned) they have encountered great difficulty.

(2) The restraint on credit markets is reflected mainly in the level of interest costs rather than in the availability of credit. For example, in both the farm and small business sectors concern generally is expressed over the cost of credit but not over its availability. This is in distinct contrast to earlier episodes of monetary restraint when widespread problems of credit availability were encountered by sound enterprises.

(3) Interest rates have contributed more substantially to the falloff in activity in some sectors than in others. The change in credit conditions certainly has taken a major toll in the homebuilding industry. The demand for goods that are, in essence, investments yielding a flow of services or income over a period of years will tend to be comparatively sensitive to movements in interest rates; to the extent that they represent large outlays,

which typically require credit financing, or are deferable, that sensitivity will be further enhanced.

(4) As interest costs have climbed to record levels, a number of innovations or market developments have evolved to ease the burdens of potential borrowers. For example, in the housing market means have developed to provide "below market rate" loans--such as through state and local government mortgage revenue bonds--or a variety of creative techniques have been employed to minimize the mortgage payment burden, especially in the early years of the mortgage contract. In the business sector, evidence indicates that rates on small loans at banks have risen less in recent years than rates on large loans.

(5) Inflation itself has taken an appreciable toll on activity. The current slump in homebuilding reflects in part an inevitable unwinding of some of the inflationary excesses of recent years, which saw house prices spiral upward to the point that many potential homebuyers would have been forced out of the market even if interest rates had not risen so much. Higher prices also have been a significant factor depressing demand for automobiles; higher car prices account for nearly 5 times as much as higher interest rates in the rise of average monthly payments for a typical new car loan since late 1979.

(6) In the farm sector, factors other than interest rates dominate the forces generating reductions in farm income. The slump in farm income since 1979 is attributable more to persistent drought conditions in some regions, and to the changing tastes of consumers and their resistance to rising meat prices in a period of constrained real income growth. High interest rates, however, have created stresses for some farm businesses, especially those that have invested substantially in land and machinery in recent years--leveraging themselves heavily with short-term debt.

(7) In the small business sector, rising interest rates likely have been a more serious problem than for large-sized firms because smaller firms on average are characterized by higher debt-to-equity ratios and heavier reliance on shorter-term or variable-rate loans. Business failure rates are up substantially, but this may reflect general product demand conditions rather than interest rate-related cash flow problems per se. Moreover, rising bankruptcy figures may exaggerate the deterioration in the fortunes of small businesses, because a liberalization of federal statutes has made it more attractive to seek the legal shelter of bankruptcy status.

(8) On the whole, high interest rates are imposing considerable restraint on the economy, with some sectors inevitably experiencing greater stress than others owing to the nature of the goods or services they produce and their particular financial characteristics. However, the difficulties of the sectors examined reflect as well a variety of factors apart from high interest rates; the distortions and imbalances created by the escalation of inflation and inflationary expectations are important among these. High interest rates do apply pressures inducing greater cost and wage efficiencies, assisting in the process of achieving a noninflationary environment. It is clear that this process is uncomfortable, but a failure to address the problem of inflation would, over the long haul, impose far greater costs on the economy than do the current high interest rates.

(9) Recognition of the unevenness of the impact of monetary restraint does raise the issue of whether excessive reliance is being placed on monetary policy in fighting inflation. While a moderation of the growth trend of money is an essential ingredient in an anti-inflation strategy, the pressures on the private business sector arising from interest rates could be alleviated by reduced federal government demands on the credit markets. This underscores the importance of further progress in the effort to move the federal budget toward balance.

III. The Housing Sector

Housing activity typically has fluctuated more widely than the economy in general. This instability primarily can be attributed to the fact that housing transactions involve the sale of a long-lived asset and typically are dependent on outside financing. These characteristics--along with the fact that a home purchase often can be temporarily delayed--make the effective demand for housing highly sensitive to the cost and the availability of credit. Owing to fluctuations in effective demand for shelter, the housing industry has been characterized by large swings in output and employment as well as by the entrance and exit of many small, weakly capitalized firms from the market as economic conditions dictate.

The Current Downturn

Housing production and sales have been greatly reduced in recent years, reversing a strong rebound in the mid-1970s. Total private housing starts declined from over 2 million units in 1978, to 1.8 million units in 1979, and to less than 1.3 million units last year. In the past two months, starts have fallen to about 1 million units, at an annual rate. Home sales also have declined sharply; in June 1981 sales of existing homes were down almost a third from the record pace registered in 1978. Likewise, June sales of new homes were at their second lowest monthly level since 1970.

Thus far, the current housing downturn has about equaled the length of the slowdown that started late in 1972 and continued through early 1975. During that period private housing starts fell to around a million unit annual rate and hovered at that level for three consecutive quarters--a severity that has yet to be sustained in the current slump.

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The diminution of activity has been accompanied by an appreciable slowing in the rate of increase of home prices. During 1978, the average price of an existing home sold rose 19 percent, and the average price of a new home (adjusted for quality changes) was up almost 14 percent. These unsustainable rates of inflation have come down sharply as market activity has softened (chart on page 8). During the year ending in the second quarter of 1981, the average price of existing homes sold rose 9-1/2 percent while the new home price series, after quality adjustments, was up 8-1/2 percent.[1]

Elements Contributing to the Current Housing Downswing

Perhaps the single most important cause of the currently depressed state of the housing market is the increased cost of acquiring housing services. While this is true throughout the industry, it is most evident in the single-family sector. The average monthly payment for principal and interest on newly purchased homes has increased dramatically in recent years. For instance, the carrying cost on an average new home actually financed in July 1981 was 175 percent above the level only five years earlier. As shown in the chart on page 9, the increased financial burden of a home purchase has far outstripped growth in average disposable income.

Skyrocketing monthly payments have reflected two factors: increased mortgage interest rates and elevated home prices. The relative contributions of these factors are illustrated in the table on page 11, in which both historical data and some hypothetical comparisons are presented. As a frame of reference, average monthly payments on a typical new home purchase rose almost

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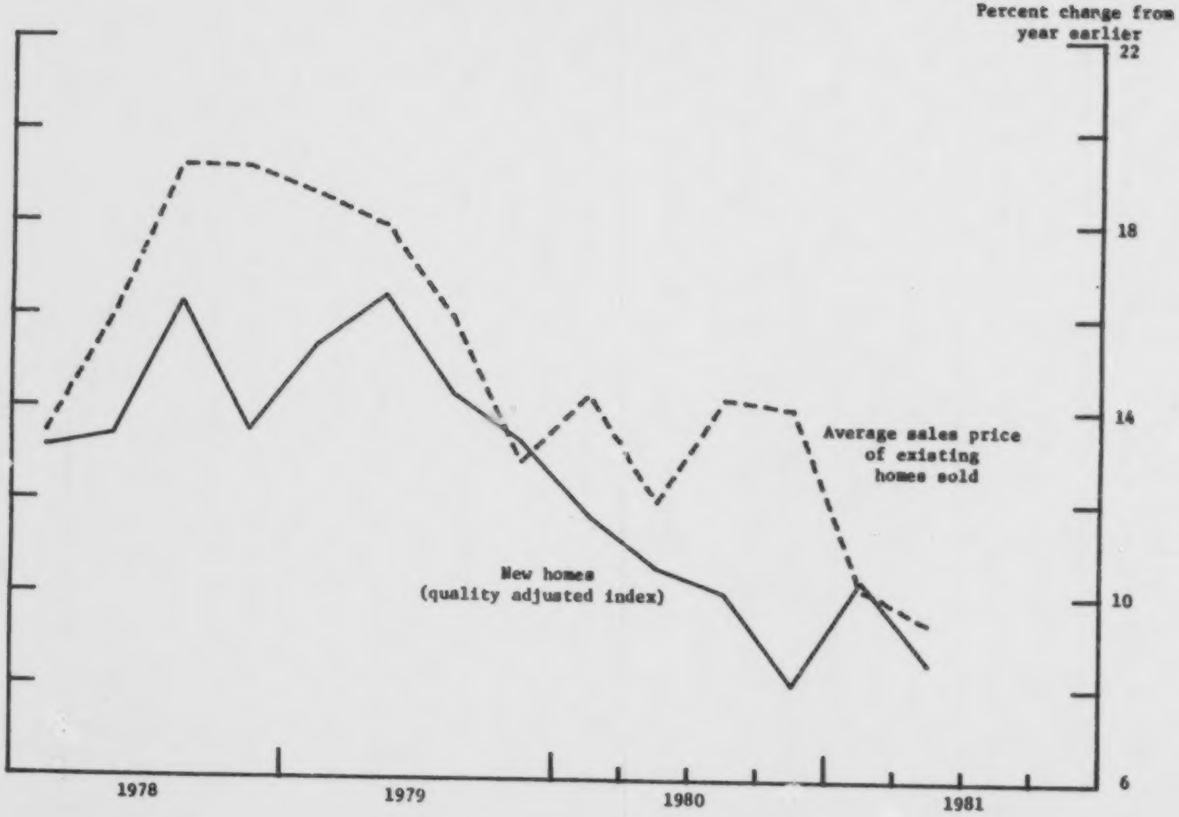
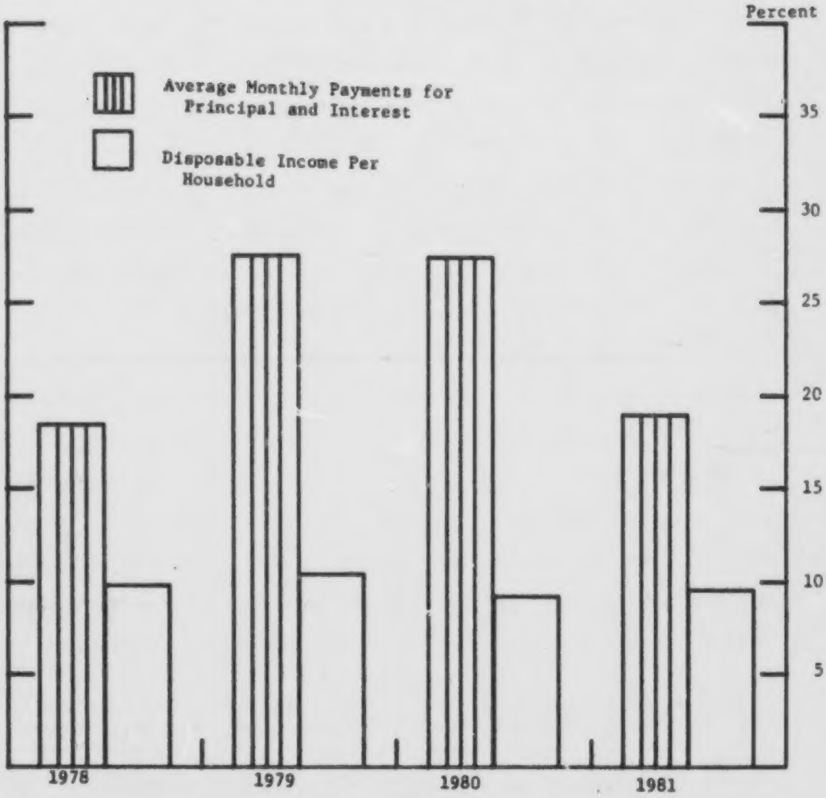
1. Recorded price increases, in fact, understate the true deceleration in home prices. The widespread use of below market "creative financing" for both new and existing home sales means that net proceeds from a sale are less than the selling price would indicate.

RECENT CHANGES IN AVERAGE HOME PRICES



TYPICAL MONTHLY PAYMENTS FOR NEW HOMES AS COMPARED
TO AVERAGE DISPOSABLE INCOME PER HOUSEHOLD
(Percent change from a year earlier)



Source: Monthly payments for conventional mortgages from the Federal Home Loan Bank Board. The 1981 numbers are for the second quarter.

four-fold during the decade of the 1970s from $220 to the current level of just over $850.[1] Higher interest rates have contributed to the increase in carrying costs, but, if home prices had remained at 1970 levels, the sharp increase in mortgage interest rates during the ensuing decade would have raised average monthly payments only to about $340. Instead, prices of homes purchased have escalated much more rapidly than inflation in general during recent years, with the national average price of a new home sold currently approaching $90,000. This compares with an average price of $35,000 in 1970 and of $65,000 as recently as three years ago. When home prices increase, downpayments rise and the larger loan amounts result in larger monthly payments. Even if mortgage interest rates had not risen at all since 1970, at current home prices an average monthly payment would be almost $570.[2]

Of course, the effect of high mortgage interest rates are not necessarily permanent burdens for homeowners. Since households are generally quite mobile, most mortgages are not held for the full term of 25 or 30 years. Even if a family were to remain in the same house, a very high rate mortgage could be refinanced--albeit at some cost--when interest rates fell. In addition, homebuyers have not had to absorb the full force of the increase in monthly payments. Most new homebuyers deduct the interest portion of their mortgage payments in computing income subject to federal income taxes.

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[1] The average interest rate on conventional loans actually closed in July was well below the rate usually reported for new, fixed-rate conventional loans. This reflects normal lags in financial markets as well as the fact that many loans are made at lower contracted mortgage interest rates. Indeed, if measured at the 17 percent average commitment rate for fixed-rate, conventional loans that has been reached this summer, the average monthly payment for a typical home would have exceeded $1000.

[2] The full increase in monthly payments is the product of the individual interest rate and price effects plus the joint effect of concurrent changes in these factors.

CHANGES IN THE TYPICAL MORTGAGE PAYMENT ON A NEW HOME PURCHASED

Period	Mortgage Interest Rate	New Home Prices	Downpayment	Monthly Payment
1970	8-1/4	$ 35,000	$ 7,000	$ 221
1979	10	65,000	13,000	473
Recent	14	90,000	18,000	867
Illustrative Calculations				
Recent Interest Rates, 1970 House Prices	14	35,000	7,000	337
Recent Home Prices, 1970 Interest Rates	8-1/4	90,000	18,000	568

Note: Illustrative figures for level-payment fixed-rate 25-year 80 percent conventional mortgage loan, largely reflecting Federal Home Loan Bank Board data for loans closed. The recent interest rate is based on data from the FHLBB which show the average contract rate for new home loans closed in July was 14.05 percent; the effective rate--including points and charges--was somewhat higher at 14.65 percent.

During the 1970s inflation raised the marginal tax bracket of many families, lowering the after-tax cost of mortgage payments.

Notwithstanding the damping influence of high carrying costs on new home purchases and construction, the slowing of activity in recent periods has been in some part a reaction to earlier inflationary developments. During the late 1970s, when home prices increased more rapidly than the general rate of inflation, large capital gains accrued to homeowners. These high returns encouraged many households to purchase a home as a residence with a view toward obtaining a hedge against inflation and spurred others to buy houses for speculative purposes. Such investment motives were encouraged by the fact that the bulk of monthly payments in the early years of most mortgages--as well as property taxes--are deductible for federal tax purposes.

Price increases of almost 20 percent per annum could not be sustained indefinitely, and, in part, the current slowdown in activity no doubt has reflected that reality. As buyers anticipated further price increases, purchase prices rose to "capture" expected future appreciation. Thus, unanticipated capital gains became harder to garner. This, in turn, had a depressing influence on real estate market activity.

The production of rental housing also has been depressed. While high construction and permanent financing costs have contributed to profitability problems in this sector, contractors also have faced other difficulties. In an inflationary environment, prospective costs are highly uncertain for real estate ventures that take considerable time to complete--as is the case with apartment buildings. Further, rent increases have lagged behind rising operating costs. During the last five years average rents advanced just over 40 percent, while costs of operation rose almost 70 percent. The risk of undertaking new rental construction also has been aggravated, in some areas, by the existence or threat of rent control laws.

Responses to High Mortgage Interest Rates

As mortgage interest rates have climbed to record levels, a number of innovations have evolved to ease the burdens on potential homebuyers. Deregulation of the thrift industry and the continued development of secondary mortgage markets have helped to break the pattern of past periods of high interest rates, when housing was virtually cut off from funds. Also, means have developed to provide "below market rate" loans, including, prominently, state and local government mortgage revenue bonds.

Many new developments in mortgage finance attempt to overcome the disproportionate financial burden imposed during the first years of a standard contract. High monthly payments relative to family budgets--or to lender qualification standards--have discouraged homebuying even when buyers still feel that purchasing a home would be a prudent investment. This is especially true with a standard, level-payment mortgage which concentrates the real burden of monthly payments in the first years of the contract when buyers' incomes are low relative to longer-term prospects.

Graduated payment mortgages now are available in which payments are designed to increase more in line with income growth. Many purchasers have been helped by seller financing concessions. Builders have offered "buydowns," in which they pay part of the buyer's mortgage for the first several years. Similarly, many sales of existing homes involve the assumption of existing, low-interest mortgages and/or a "second" mortgage--often at below-market rates. Finally, financial institutions have offered many of their new adjustable or renegotiable mortgage loans at initial interest rates below the rate for standard, fixed-rate mortgages; lower rates early in such mortgages often come, however, at the expense of uncertainty about mortgage costs in the future.

The Effect of High Interest Rates on Home Builders

The primary effect on home builders of high interest rates is the diminution of demand for their product. But high interest rates also have discouraged the output of new housing by pushing up construction loan rates and increasing the cost of production. Further, while the number of unsold new homes on the market has remained low in historical perspective, the cost of carrying these inventories has been quite high. Weakened housing demand makes the builder's ability to pass on these costs more difficult than would otherwise be the case.

Data for business failures are not available for the residential construction sector alone. However, for the entire construction industry, failures have increased more sharply in the last three years than in previous downturns. Dun & Bradstreet reports an increase of 160 percent in the number of such failures since early 1978; this compares to just over 110 percent in the 1972-1975 period. Some of this increase may be explained by recent liberalization of the bankruptcy laws, which has made it more attractive for businesses--as well as individuals--to seek the shelter of the courts than formerly was the case. In any event, the level of failures relative to the number of operating builders has continued to be quite low.

Current financial difficulties probably have fallen most heavily on small home builders, who often are at a competitive disadvantage in periods of high interest rates. Their sales are not so broad in terms of numbers or geography as larger competitors, so that a given downturn in sales may be more likely to cause extreme financial distress. Moreover, small builders are typically less well capitalized than larger producers and, thus, are more exposed financially to cyclical downturns. Finally, because of their more uncertain prospects, small builders are more likely to be squeezed out of financial markets when money is tight and lenders become more selective. These problems were confirmed in a recent survey by the National Federation of Independent Business which found that more than two-fifths of small business respondents in the construction industry indicated that interest rates and financing was their most important problem; in the same survey, fewer than one-fourth of other small businesses responded similarly.

Coping with High Housing Costs

While construction of housing units has been curtailed sharply, households have made numerous adjustments in an effort to meet their shelter needs. Some households have looked for alternatives to buying a "traditional" home. For instance, manufactured (mobile) homes have been providing a lower-cost form of shelter for many households. In May of this year--the most recent reading available--mobile home shipments were running 15 percent above the average 1980 pace, despite the fact that financing costs for such units were running at record levels. In addition, many households have improved and/or expanded their existing living quarters. While spending on new housing units declined 16 percent between 1978 and 1980, outlays on additions and alterations rose more than a third.

Even households seeking new housing units have made adjustments to limit their monthly mortgage payments. During the late 1970s the average price of a new home sold rose more than construction costs, as homebuyers were upgrading the units being bought. Besides reflecting a desire for increased amenities, many buyers apparently purchased larger and more expensive homes to enhance the investment value of the unit. That is to say, many homebuyers bought "all the house they could afford," expecting to maximize their capital gains. Since late 1979 this pattern has been reversed, with the average price of new homes sold rising less than basic costs. Also, condominiums and cooperatives--a generally less expensive form of ownership--have increased in popularity. In the first quarter of 1981, such units in multifamily structures were started at an annual rate of 233,000--the fastest pace since such data has been reported (1974).

IV. The Automobile Sector

Sales of domestic autos in the first half of 1981 were at a 6.5 million unit annual rate, about the same as the 1980 average but down nearly 25 percent from the average selling pace during the 1970s. Sales of domestically produced trucks have been even more hard-hit recently, off more than one-third from the peak selling rate in 1979. At the same time, employment and profits at auto makers and related industries have suffered.

These difficulties in the motor vehicle sector of the economy are related to a number of factors. In part, the drop in sales and production is due to the typical cyclical volatility in auto and truck demand. The problems in the motor vehicle sector also are related to recent credit market conditions, which have affected the cost of financing new car and truck purchases. However, the current problems in the industry appear to be related mainly to longer-term trends in automotive demand. These include: the high cost of buying and operating a new car, sluggish household income growth, and the squeeze on family budgets over the past few years arising from rapid increases in the prices of necessities such as food and energy. Moreover, the industry has been plagued by intense foreign competition and by government regulations that have necessitated large investments to comply with emission control standards and improved fuel efficiency requirements.

Current financing conditions for autos at retail

Interest rates on new consumer auto loans are at record levels, although they still are well below the prime rate charged by banks on business loans or the best available commercial paper rate. Interest rates on new auto loans averaged 16 percent in May for 36-month loans financed by commercial banks. This compares with an interest charge of about 13 percent at the end of 1979 and a rate generally around 10 percent in the early seventies. In recent years, commercial banks have held almost 60 percent of automobile credit outstanding, although their market share dropped to 52 percent in 1980. Finance companies--primarily the subsidiaries of the auto manufacturers--expanded their share in 1980 by an equivalent amount, to about 30 percent of the market. New-car interest rates have risen over the past two years at these lenders as well, though not so steeply as at banks. In contrast to the usual 1-to-2 percentage point spread of finance company over bank rates, the average rate on a new-car loan at finance companies was also 16 percent in May.

Despite the high level of interest rates, the effect on average monthly payments has been relatively small. The 3 percentage point rise in interest rates for automobile loans since the end of 1979 has added about $9 to the average monthly payment rate for a typical car loan (see the lower panel of the table on page 19).[1] At the same time, the sticker price of a typical new domestic car has gone up about $1,900, adding about $44 to monthly payments--five times the amount added by higher rates. An increase in the average new car loan maturity to 45 months has provided a small offset, reducing typical monthly carrying costs by $2.50.

There have been reports of reduced availability of auto loans at commercial banks, and auto installment credit outstanding has contracted a bit at banks over the past year and a half. However, finance companies have helped maintain an ample flow of credit to the auto market, with the finance

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[1] These figures are based on an assumed 20 percent downpayment with an average loan balance of $5,600 financed in late 1979.

NEW-AUTO LOANS

Typical Prices and Loan Terms

Period	Price of new cars[1] (dollars)	Amount financed[2] (dollars)	Interest rate[3] (percent)	Maturity[4] (months)	Monthly payment (dollars)
1979-Nov.	7,000	5,600	12.85	44.3	159.42
1980-Feb.	7,254	5,803	13.28	44.5	165.84
May	7,507	6,006	15.72	44.4	179.26
Aug.	7,821	6,257	13.91	45.0	179.24
Nov.	8,646	6,917	14.29	44.8	200.13
1981-May	8,936	7,149	16.04	45.2	211.79

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1. Initial price of $7,000 has been rounded for computational ease; the estimated average price of a domestic auto in the GNP accounts in November 1979 was $7,190. Price in subsequent months is determined by multiplying the initial price by an index reflecting percentage changes in the unweighted average of manufacturer's suggested list price for base car of four popular models: Oldsmobile Cutlass, Chevrolet, Ford Fairmont, and Toyota Corolla.
2. Calculated as 80 percent of price from first column.
3. Average most common finance rate on 36-month new car loans at a sample of commercial banks.
4. Weighted average maturity on all new-car loans at finance company subsidiaries of the domestic auto manufacturers. Data on loan maturities at commercial banks are not available; however, qualitative evidence suggests that the maturity structure of auto loans is similar at commercial banks and finance companies.
5. Calculated from Board's Regulation Z tables on annual percentage rates.

Change in Monthly Payment From November 1979 And Distribution By Source of Change

Period	Total change in monthly payment from November 1979 (dollars)	Dollar amount of change in monthly payment due to change in			
		Car price	Interest rate	Maturity	Interaction[1]
1980-Feb	+6.42	+5.78	+1.18	-.56	+.02
May	+19.84	+11.55	+1.18	-.56	+.02
Aug.	+19.82	+18.70	+2.94	-2.24	+.42
Nov.	+40.71	+37.49	+3.99	-1.40	+.63
1981-May	+52.37	+44.09	+8.93	-2.46	+1.81

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1. Reflects concurrent changes in price, interest rate, and maturity.

affiliates of the major auto makers playing a major role and at times offering major interest rate concessions to car buyers.

Evidence from consumer surveys on respondents' views about credit conditions is mixed. On the one hand, the University of Michigan Survey Research Center reported in July 1981 that 25 percent of those surveyed who answered that the market condition for autos was poor gave as a rationale: "High interest rates; credit is tight." This is a near-record high for this response. On the other hand in response to a separate question, "tight" credit has been mentioned by less than 10 percent of respondents who gave an economic factor as an item of unfavorable news for the past several months. This compares with 25 percent of the respondents complaining about tight credit during the credit control program in April of last year.

Nonfinancial Factors Affecting Household New Auto Demand

The high cost of buying and operating a new car, relatively sluggish growth of real personal income, and rapid increases in the prices of necessities are probably the main factors depressing the demand for autos. Of these factors, perhaps the most important is the high cost of autos. Throughout most of the fifties and sixties, car prices were on a downtrend relative both to other prices and to disposable personal income. This downtrend was interrupted in 1974 and for the next five years the ratio of new car prices to other prices and income was more or less stable. However, since 1979 the price paid for a typical new domestic auto has moved up quite sharply. (See top panel of the table on page 19.) The 27 percent increase in the sticker price of four popular domestic models over the past two years compares with only a 16 percent increase in nominal disposable personal income. Reflecting these movements, households responding to the University of Michigan's consumer attitude survey have consistently reported over the last few years that high car prices are the major deterrent to purchasing a new auto.[1]

As a result of the rapid increases in car prices--and the high average prices paid for domestic units--households increasingly have chosen to hold on to their used cars, making repairs when needed, rather than buying new ones. For example, in 1970 less than 12 percent of registered passenger cars were more than 10 years old; by 1980 the figure had climbed to almost 21 percent. This behavior is not surprising, since it is estimated that last year it was 40 percent cheaper to drive a typical used car than a new 1980 model.[2] Consequently, the average age of the passenger car fleet has increased from 5.5 years in 1970 to 6.6 years in 1980--the highest level since the mid-1950s (chart on page 22).

The high costs of operating a car have led to less intensive use of the auto stock, and this has reduced replacement demand. The near tripling of gasoline prices in recent years has resulted in increased annual fuel costs of about $500 per passenger car. Reflecting these higher costs, the average number of miles driven per year has dropped from 10,184 miles in 1972 to an estimated 9,400 miles in 1980. Rising operating costs also were a factor in the shift toward smaller cars--a market where foreign producers play a large role. A study by the Hertz Corporation shows that the average cost to own and operate a subcompact car was just over 38 cents a mile in 1980; this compares with a cost of 44 cents for mid-size cars and 48 cents for larger cars.[3]

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[1] Only in May 1980, during the period of credit controls, were high interest rates and credit conditions mentioned nearly as often as high prices.

[2] Estimate is from Hertz Corporation.

[3] This differential reflects depreciation and insurance in addition to gasoline per mile expenses.

Sluggish growth of real disposable personal income also has been a major factor in the poor sales performance of the auto industry. Since 1973, gains in real disposable income per household have averaged only 0.6 percent per year, compared with a 1.9 percent trend over the preceding two decades (chart on page 23). Moreover, most family budgets have been under extreme pressure from increases in the prices of necessities--such as food and energy--relative to income growth. In the 1959 to 1973 period, outlays for necessities decreased as a share of family disposable income from 30 percent to less than 25 percent. This trend was reversed in 1974, however, and most families must now allocate about the same share of disposable income to these necessities as they did in the early sixties (chart on page 24). Thus, with income growth slow and prices of necessities rising rapidly, households have found less room available to purchase discretionary goods such as new cars.

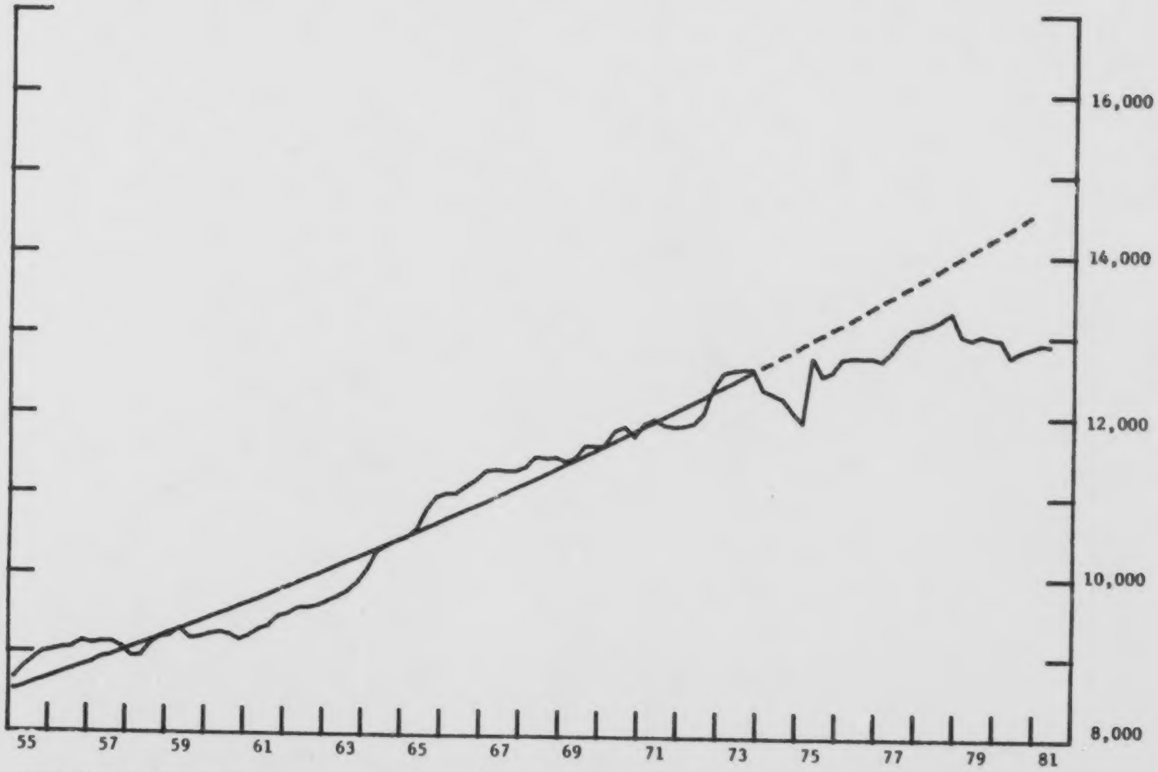
Truck sales

The sharp decline in truck sales over the past 1-1/2 years reflects a number of factors: high interest rates, the general slowdown in economic activity last year, and a reluctance by business to invest in plant and equipment in an uncertain inflationary environment. In addition, demand for vans and smaller trucks--many of which are purchased for consumers' use--continued to be sensitive to the relatively low fuel economy of these vehicles. Moreover, foreign competition has been even more intense for trucks than in the passenger car market. Recognizing this problem, in August 1980 the tariff on imported light-duty trucks was raised from 4 to 25 percent.

Economic Health of the Industry

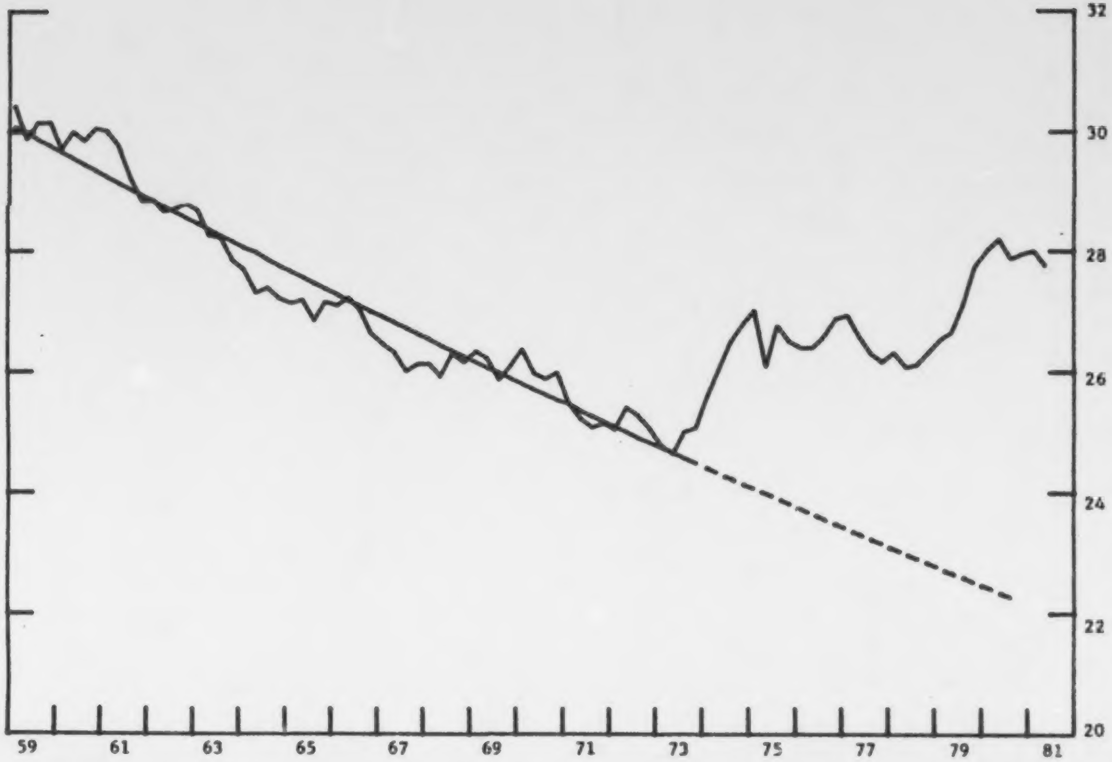
Reflecting the weakness in auto and truck demand, firms in the motor vehicle industry posted losses of more than $4 billion in 1980, and they still were running in the red during the first quarter of this year

REAL DISPOSABLE INCOME PER HOUSEHOLD



Trend Fitted 1955-1973

FOOD, GASOLINE, AND UTILITIES AS A PERCENTAGE OF DISPOSABLE PERSONAL INCOME



Trend Fitted 1959-1973

(table on page 26).[1] During the years 1976 through 1978, the motor vehicle industry accounted for more than 10 percent of all profits in manufacturing. The rubber and plastic products industry (not shown on the table) is an important supplier to the auto industry. This industry reported lower profits in 1980 than in 1979, with net profits per dollar of sales around 2 percent. According to industry reports, profits improved substantially in the first quarter of this year, rising to 3.6 cents per dollar of sales.

Weak profits also have affected retailers. Although the number of dealerships has been declining steadily since 1956, last year 1,600 dealerships handling domestic makes of passenger cars went out of business--the largest one-year decline in retail outlets since 1966 when Studebaker left the car business. Another 220 dealerships folded in the first quarter of this year. High inventory carrying costs and the marked slowdown in automotive sales have played an important role in the troubles facing dealers. However, part of the problem for automotive dealers is related to the used car market. It is estimated that about 20 percent of most new car dealers' dollar volume is accounted for by used cars. But used vehicle sales by car dealers have been declining in recent years, putting a further squeeze on profit positions.

With a more stable price environment and the associated easing in credit market conditions over the longer-term, the automotive and related industries should be in a good position to benefit from renewed prosperity. Indeed, part of the improvement should be attributable to changes which have contributed to recent losses--e.g., the substantial retooling and other costs

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[1] Second quarter data on profits in the motor vehicle industry are not yet available in the National Income and Product Accounts. Industry reports, however, indicate that the three largest auto makers posted small profits in the second quarter.

MANUFACTURING AND MOTOR VEHICLES AND PARTS
BEFORE-TAX PROFITS WITH INVENTORY VALUATION ADJUSTMENT

	Total Manufacturing	Motor Vehicles
	----------Billions of Dollars, SAAR------------	
1976-.............	69.2	7.2
1977-.............	76.1	9.2
1978-.............	85.3	8.9
1979-.............	88.9	4.3
1980-.............	74.5	-4.3
1980-Q1...........	92.1	-2.9
-Q2...........	61.3	-8.8
-Q3...........	68.5	-4.8
-Q4...........	76.2	-0.8
1981-Q1...........	91.4	-1.7
	---Percent Change from Preceding Period, SAAR---	
1976-.............	31.7	278.9
1977-.............	10.0	27.8
1978-.............	12.0	-3.3
1979-.............	4.2	-51.4
1980-.............	-16.1	n.a.
1980-Q1...........	73.9	n.a.
-Q2...........	-80.4	n.a.
-Q3...........	55.9	n.a.
-Q4...........	53.1	n.a.
1981-Q1...........	107.0	n.a.

n.a. = Not applicable; level of profits is negative in the period.

Source: National Income and Product
Accounts, Bureau of Economic
Analysis.

associated with the production of small, fuel efficient cars that meet government regulations and are also more competitive with imported units. Moreover, movements within the industry to consolidate production of key products and an increasing willingness to make joint-ventures--both with domestic producers and foreign companies--should lead to increased productivity.

Two factors that have put domestic automakers at a disadvantage with foreign competitors are their high average labor costs and a perception by the public that foreign made autos are higher in quality. However, U.S. manufacturers have taken steps to try to reduce these disadvantages. Workers at Chrysler agreed early this year to a pay cut that returned their straight time wage rate to the level prevailing at the end of 1979; they also agreed to forgo any additional wage hikes for the duration of the current contract (due to expire September 1982). Actions such as this should help to narrow the 70 percent compensation differential between U.S. and Japanese automakers.[1] In addition to controlling labor costs, domestic manufacturers have undertaken strenuous efforts to improve the quality of their products--especially those that compete most directly with foreign models. Despite the recent wage concessions and quality improvements, the domestic industry still faces strong competitive pressures from abroad.

The situation for dealers should improve. They are becoming more involved with the distribution of foreign units and their profits should benefit from this increased volume, although most industry experts expect the market share of foreign units to fall back with the increased competition of better designed U.S.-made smaller cars. Also, the manufacturers are actively working with dealers in developing lucrative "after-sale" business, which at present mainly consists of service still under warranty.

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[1] New York Times, June 3, 1981, page D-1.

V. The Farm Sector

The farm sector is now experiencing its seventh consecutive quarter of relatively low profitability (see table on page 29). Although this slump has occurred during a period when interest rates have risen to historically high levels, a glance at the data on farm income for the past decade would suggest a need for caution in drawing conclusions about causal linkages. For instance, the last period of relatively weak farm profitability, 1976-77, occurred during a period of lower interest rates. Farm income then rose rapidly in 1978-79 even though interest rates had started to climb. And earlier, in 1973, the highest farm income in history was recorded while market interest rates were rising sharply.

As these historical references indicate, the farm sector has experienced relatively severe income cycles over the past ten years. First came the extraordinarily profitable years of 1972-73, then an income slide that by 1976 had carried the real earnings on farm assets below their longer-term trend of annual increases averaging 4 percent since the mid-1950s. This longer-term profit growth had been accompanied by an equivalent average annual increase in the real price of farm real estate; furthermore, the relatively high price/earnings ratio placed on farm assets--averaging about 25--reflected expectations that such real growth in asset earnings would be sustained. The income recovery of 1978-79 returned farm profitability to approximately the longer-term trend to which farm real estate values were evidently related. The swift return to lower earnings that ensued seemingly was an unexpected shock.

Higher interest rates could have cut into net farm income in four ways: (1) by increasing production expenses directly, through higher interest

Table 1. Farm income and expenses (quarterly, seasonally adjusted annual rate, billions of dollars)

Quarter	Gross farm income	Farm production expenses	Net farm income of farm operators
1978-Q1	120.4	97.7	22.7
Q2	124.1	99.1	25.0
Q3	126.9	100.4	26.5
Q4	138.9	107.2	31.7
1979-Q1	148.2	114.8	33.4
Q2	152.8	116.9	35.9
Q3	152.5	120.2	32.3
Q4	154.1	124.9	29.2
1980-Q1	149.3	126.0	23.4
Q2	146.0	129.0	16.9
Q3	151.9	132.2	19.7
Q4	155.1	135.6	19.5
1981-Q1	157.7	139.4	18.3
Q2	165.2	142.2	23.0

Source: U.S. Department of Agriculture.

charges on debt owed by the farm sector; (2) by increasing production expenses indirectly, as higher interest charges paid by nonfarm manufacturers and suppliers of goods and services to the farm sector are passed along in the form of higher prices of these farm inputs; (3) by reducing gross income through adverse effects on the demand for farm output; and (4) by changing the time-path of gross income if higher rates cause producers to alter their marketing patterns.

Data available permit rough empirical estimates of the first two of these effects. To establish a perspective for such estimates, it is first useful to quantify the extent to which farm income has fallen below its 1979 level. As such income is to be compared with interest expense, it must include the net rent of farm landlords as well as the net income of farm operators, because landlords owe part of the farm debt and thus pay part of the interest included in farm production expenses. The table on page 31 shows that the combined net farm income of operators and landlords, labeled "net income of farm sector," totaled $38.1 billion in 1979. Between 1979 and the first half of 1981 (1981-H1), the price deflator for personal consumption expenditures rose 17.1 percent; thus, to provide the same purchasing power, such income would have had to total $44.6 billion (annual rate) in the latter period. As also shown in in the table, actual sector net income totaled $26.5 billion (annual rate). Thus the reduction in annual net income, in terms of current purchasing power, was approximately $18 billion as of the first half of 1981.

The rise in interest rates on outstanding farm sector debt is estimated to have accounted for $2.4 billion, or 13 percent, of this drop in real net income. Thus, so far, for the farm sector as a whole, the direct

Table 2. Farm income and expenses (annual, billions of dollars)

Year	Gross farm income	Farm production expenses	Net farm income of farm operators	Net farm income of farm sector	Farm cash flow of farm sector	Farm cash flow of farm sector plus farm operators' off-farm income
1977	108.7	90.3	18.4	22.4	37.8	63.1
1978	127.5	101.1	26.5	31.4	48.7	76.8
1979	151.9	119.2	32.7	38.1	57.8	91.0
1980	150.5	130.7	19.9	25.7	47.4	83.4
1981-H1[a]	161.4	140.8	20.6	26.5e	49.0e	87.0e

a - Annual rate.
e - Estimated for this report.

Source: U.S. Department of Agriculture.

Notes: Data for the first half of 1981 (1981-H1) are shown at annual rates.

Gross farm income includes cash receipts from farm marketings, government payments, net change in inventory of livestock and stored crops, home consumption of farm output, and the rental value of operators' dwellings. Share rents and government payments received by landlords are also included.

Farm production expenses are as reported by the USDA. They include landlords' farm production expenses as well as net rent paid to farm landlords.

Net farm income of farm operators is gross farm income less farm production expenses.

Net farm income of farm sector is net farm income of farm operators plus net rental income of farm landlords.

Farm cash flow of farm sector is net farm income of farm sector plus the capital consumption allowances that were included in farm production expenses.

Table 3. Outstanding farm debt, interest paid, and interest rates

Year	Average outstanding debt (billions of dollars)	Annual interest paid (billions of dollars)	Implicit average interest rate (percent)	Addendum: Average interest rate on loans made (percent)		
				Commercial banks	Production credit associations	Federal land banks
			Non-real-estate debt			
1976	43.1	3.2	7.39	n.a.	8.4	--
1977	51.2	4.0	7.76	8.8	8.1	--
1978	60.3	4.9	8.13	9.6	9.0	--
1979	70.4	6.6	9.34	11.8	10.9	--
1980	80.1	8.5	10.62	15.1	13.0	--
1981-H1	86.5e	9.9a,e	11.50e	17.9	14.3	--
			Real estate debt			
1976	53.7	3.9	7.18	--	--	8.6
1977	60.3	4.4	7.24	--	--	8.3
1978	67.4	5.1	7.60	--	--	8.4
1979	77.3	6.1	7.96	--	--	9.2
1980	88.2	7.3	8.29	--	--	10.4
1981-H1	95.0e	8.1a,e	8.55e	--	--	11.0
			Total debt			
1976	96.8	7.0	7.27			
1977	111.5	8.3	7.48			
1978	127.7	10.0	7.85			
1979	147.7	12.7	8.62			
1980	168.3	15.8	9.40			
1981-H1	181.5e	18.1a,e	9.96e			

a - Annual rate.
e - Estimated for this report.

Table 3. (continued)

Source: Debt and annual interest paid, U.S. Department of Agriculture; interest rate on loans made by commercial banks, Federal Reserve survey of terms of bank lending to farmers (dollar-weighted average of effective rates on non-real-estate farm loans of $1,000 or more made in the first full business week of the second month of each quarter); interest rate on loans made by production credit associations and Federal land banks, computed for this report as the unweighted average of quoted rates on the first day of each quarter, as compiled by the Farm Credit Administration (stock purchases and loan fees required of borrowers from these cooperatives are not taken into account in the average rates shown).

Note: Average outstanding debt was computed for this report as follows, in order that the seasonal pattern of debt outstanding be reflected in the annual average: (1) quarterly average institutional debt (compiled in Federal Reserve Board Statistical Release E.15, "Agricultural Finance Databook--Quarterly Series") was estimated by averaging amounts outstanding at the beginning and end of each quarter; (2) annual average of institutional debt was estimated by averaging the quarterly averages computed in step 1; (3) annual average institutional debt was alternatively estimated by averaging amounts outstanding at the beginning and end of each year; (4) annual average total debt was first approximated by averaging amounts outstanding at the beginning and end of each year (USDA estimates of noninstitutional debt are made only as of January 1); and (5) the amount obtained in step 4 was adjusted by multiplying by the ratio of the amount obtained in step 2 to the amount obtained in step 3. These computations were performed separately for non-real-estate and real estate debt, and the results were summed to obtain average total debt.

cost impact of higher interest rates has been small. The key factor is that a relatively large amount of outstanding intermediate- and long-term farm debt was incurred in earlier years at lower fixed rates; also, a significant amount of recent new debt consisted of drought-related Farmers Home Administration disaster loans bearing an interest rate of 5 percent. Consequently, the average rate on all outstanding debt rose relatively slowly toward the new higher level of rates on most other new loans. As shown in the table on page 32, the average rate paid on all outstanding farm debt in the first half of 1981 is estimated to have been 9.96 percent, up from 8.62 percent in 1979. Total interest paid rose from $12.7 billion to an estimated $18.1 billion (annual rate). But much of this increase resulted from a sizable growth in the amount of outstanding debt, from $147.7 billion to $181.5 billion. Thus even if the average interest rate had remained at its 1979 level, interest paid would have risen to $15.6 billion. Only the remaining $2.4 billion of the total increase is attributable to the higher rate.

Some individual farm operators, of course, have experienced a much greater relative increase in their average interest rate--in particular, those highly leveraged operators who have employed significant short-term financing. Because short-term borrowing often tends to minimize immediate interest expense while maximizing financial flexibility, persons seeking rapid financial progress may choose such financing in spite of the obvious risk of greater susceptibility to cash-flow problems should interest rates subsequently rise. In effect, some individuals chose to take above-average risks in the hope of above-average short-term gains, and their timing proved, in retrospect, unfortunate. Data on the number of these or other cases of individual farm financial distress are limited, however. Foreclosures, which would tend to be a lagging indicator of severe problems, in 1980 accounted for 0.13 percent of farm transfers, about the same as the average proportion over the past two decades.

Average interest rates being paid by nonfarm businesses also have lagged behind advances in rates on new loans, thus holding down the size of the indirect impact of higher rates on farm expenses for nonfarm inputs. If firms supplying farm inputs had credit experience similar to that of nonfinancial corporate business in general, a full pass-through of their own cost increases attributable to higher interest rates paid since 1979--which may not have been possible, given demand conditions--would have raised the price of their final sales by about 1.0 percent. Annual farm sector purchases of such inputs have recently totaled about $60 billion; thus, at most only about $0.6 billion, or 3 percent, of the reduction in real net farm income resulted from this indirect impact of higher rates.

The third avenue through which, as was noted above, higher interest rates might have reduced net farm income was by reducing demand for farm commodities. Stagnant gross farm income has been the proximate cause of the decline in net income. After rising above $150 billion in the second quarter of 1979, gross farm income failed to advance significantly further until the second quarter of this year (table on page 29). In an environment of general price inflation approaching 10 percent annually, two years of stalled growth in gross income had a devastating effect on net income.

High interest rates undoubtedly have had some effect on the growth path of gross farm income. However, these effects have worked mainly through indirect channels and are thus hard to disentangle from other causal factors--such as the impact of languishing labor productivity on real consumer income--that have probably been more important in limiting farm income growth. More than likely, the direct effect of high interest rates in limiting the demand for farm output has been quite small since, by and large, final consumer purchases of farm output are neither credit-financed nor highly postponable. Thus an increase in rates should have relatively little influence on either the level or timing of consumer food purchases.

While the direct effects are probably small, many observers have argued that high interest rates have restricted farm income growth indirectly through exchange rate effects that limit farm export demand. According to this argument, high U.S. interest rates contribute to the strength of the dollar in exchange markets and thereby make U.S. goods more costly relative to those of other countries. Conceptually, there is merit to this argument; however, the magnitude of the exchange rate effect on recent farm income developments could easily be exaggerated. Although exports of the major U.S. crops in the 1980-81 marketing year will apparently fall short of earlier expectations, these exports are still at very high levels by historical standards. Moreover, the cash receipts of farmers producing our major export crops have in general held up better than the incomes of livestock producers, who--in the short run--should not be much affected by exchange rate developments.

Yet another way in which interest rates might affect farm prices and farm incomes is through their effect on the pattern of crop and livestock marketings. Rising interest rates make it more costly to finance inventories and thus encourage increased near-term marketings at the expense of long-run supplies. This argument has been cited especially often in the popular press as a factor explaining the weakness in livestock prices in recent quarters. However, as with exchange rate factors, it is easy to exaggerate this effect.

For example, while cattle marketings so far in 1981 have run somewhat above earlier expectations, there has not been a massive selloff of breeding animals that would severely limit future supplies; indeed, the nation's cattle inventory as of July 1 was 2 percent above its year-earlier level, and the pool of animals targeted for entry into the breeding herd was up considerably from a year earlier. In contrast, the pork industry is cutting back from recent output levels, but these cutbacks appear to be part of the normal cyclical process that has characterized that industry for several decades. The marketing decisions of crop farmers may also be influenced to some extent by high interest rates that raise carrying costs. However, for these storable commodities, increased marketings and lower prices in the near term would, with all else constant, be offset by reduced marketings and higher prices later in the marketing year.

Thus, although interest rates are affecting gross farm income in various ways, these effects do not represent the dominant factor limiting income growth. Among other factors, it is notable that real per capita incomes have grown little over the past year and a half, and that at least temporarily the pattern of consumer spending appears to have shifted away from red meats, particularly beef--a factor which helps explain the adverse income developments of livestock producers. In addition, drought and other special forces have adversely affected the incomes of farmers in certain regions.

Finally, past periods of high interest rates were often associated with reduced credit availability at institutions engaged in farm lending, particularly at the larger commercial banks. At present, with interest-rate ceilings on major types of deposits removed or tied to market rates at banks of all sizes, the potential for credit-availability problems has been greatly reduced; however, interest rates on bank loans necessarily have become more responsive to movements in market rates that change banks' cost of loanable funds. With farm credit readily available, farm sector debt outstanding increased by 10.6 percent in 1980 even though amounts of expenditures that are often credit-financed rose more slowly or, in the case of machinery purchases and real estate transfers, actually declined. The rise in borrowings has continued in 1981; during the first half of this year, farm loans outstanding at major lending institutions are estimated to have risen by about $10 billion, or 7.7 percent.

VI. Small Business

Unlike the other three sectors on which this report focuses, that is, agriculture, housing, and autos, the small business "sector" includes firms operating in all parts of our economy. Therefore, generalizing about the impact of high interest rates on small businesses is difficult, since the impact on such a diverse group of firms depends to a great extent on factors specific to each industry.

There are two other major problems in any analysis of small business conditions. First, there is no consensus on how to define small business, although there is general agreement that small businesses account for a very large percent of firms in the United States. According to the report by the White House Commission on Small Business,[1] there are about 12 million small firms in the United States, accounting for more than 97 percent of all businesses. The second problem, which in part reflects the definitional problem, is the lack of a comprehensive data base on small business. There are, however, a number of sources of information that can be used in evaluating small-business conditions.[2]

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[1] America's Small Business Economy: Agenda for Action, Report to the President by the White House Commission on Small Business, April 1980.
[2] These sources include, but are not limited to, the following: Economic Letter, National Small Business Association; Federal Monetary Policy and its Effect on Small Business. Report of the Committee on Small Business, U.S. House of Representatives, September 30, 1980 (House Report); The Heller/Roper Small Business Barometer, Walter E. Heller International Corporation Institute for the Advancement of Small Business Enterprises; Quarterly Economic Report for Small Business and unpublished data, National Federation of Independent Business (NFIB Survey); Quarterly Financial Reports of the Federal Trade Commission (QFR); Statistics of Income compiled by the Internal Revenue Service (SOI); Survey of Terms of Bank Lending, Board of Governors of the Federal Reserve System (STBL).

Small Business Financing

Despite the heterogeneity of small business, the vagueness of definition, and the limited data base, there are some relatively common financial characteristics of small businesses that permit a rough assessment of the impact of credit conditions on the group as a whole. First, small business firms tend to place a relatively heavy reliance on debt financing. Particularly for new firms, access to equity capital may be limited by the high risk of failure. For small businesses generally, however, fixed transactions expenses may make equity offerings prohibitively costly. Thus, small businesses on average have higher debt to equity ratios than larger businesses.[1] Moreover, for firms that are otherwise similar, the debt-service burden relative to cash flow tends to be higher for small businesses than it is for large companies.

Another common feature of small businesses is that, while they may have several potential sources of credit, including trade credit, finance companies, and the government, they do tend to rely heavily on commercial banks for financing. For example, according to survey data supplied by the National Federation of Independent Business for April 1980, more than 80 percent of the responding small business borrowers list a bank as the source of their most recent business loan. A survey taken for the House Subcommittee on Access to Equity, Capital and Business Opportunities yielded similar results.

These characteristics of small business suggest that the impact of high interest rates on this sector will depend considerably on the loan rates charged by banks and on the small businesses' perceptions of credit availability.

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[1] Evidence of higher debt to equity ratios for smaller firms as compared to larger firms can be seen in the QFR, SOI, and the House Report.

In this regard, data suggest that current credit conditions do not appear to be having a disproportionate effect on the level of rates paid by small businesses. The Federal Reserve Board's May 1981 Survey of Terms of Bank Lending shows that the weighted averages of commercial and industrial business loan rates for all loan size classes, for all bank size classes, and for both long and short maturities were generally over 19 percent (see table on page 42). The smaller loans at the small banks, which likely represent loans to small businesses, tended to have lower average rates than the loans at the large banks.[1] In addition, the historical data from the same survey show that small loan rates have increased less than large loan rates since 1977 reversing the spread of small loan rates over large loan rates that prevailed at that time.

These data are consistent with NFIB's two quarterly polls of its members for 1981. These show that small firms paid an average of 17.6 percent on short-term loans in the first quarter of 1981 and 18.9 percent in the second quarter. The number of loans at rates of 18 percent or less increased slightly to 64 percent in the first quarter of 1981 from 60 percent in the fourth quarter of 1980, but declined substantially to 40 percent in the second quarter. Recent data prepared by the Small Business Administration (SBA) show that about 45 percent of the loans made under the SBA's 7(a) loan guarantee program for fiscal year 1981 through May 31 were at rates below 17 percent.

Thus, although interest rates are high by historical standards, small businesses have not experienced disproportionate increases in rates they must

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[1] It should be noted that large businesses tend to have better access to commercial paper and other financing vehicles, often at relatively attractive rates, so that the comparison of bank rates does not give a complete picture.

SURVEY OF TERMS OF BANK LENDING
WEIGHTED AVERAGE INTEREST RATE
ON LOANS MADE DURING MAY 4-9, 1981

(Rates in percent; loans in thousands)[1]

SHORT-TERM COMMERCIAL AND INDUSTRIAL LOANS

	All Sizes	$1-24	$25-49	$50-99	$100-499	$500-999	$1,000 & over
All banks	19.99	19.45	19.87	19.10	19.93	19.58	20.14
48 large banks	20.29	20.64	20.69	20.52	20.36	20.18	20.28
Other banks	19.45	19.34	19.71	18.82	19.79	19.28	19.45

LONG-TERM COMMERCIAL AND INDUSTRIAL LOANS

	All Sizes	$1-99	$100-499	$500-999	$1,000 & over
All banks	19.25	19.22	19.34	19.48	19.23
48 large banks	19.20	19.90	19.54	19.32	19.16
Other banks	19.40	19.10	19.26	19.70	19.68

CONSTRUCTION AND DEVELOPMENT LOANS[2]

	All Sizes	$1-24	$25-49	$50-99	$100-499	$500 & over
All banks	19.09	19.83	19.06	19.06	20.74	19.35
48 large banks	20.17	21.62	21.09	21.01	20.56	19.89
Other banks	18.72	19.74	18.89	18.87	20.79	18.89

LOANS TO FARMERS

	All Sizes	$1-9	$10-24	$25-49	$50-99	$100-249	$250 & over
All banks	17.88	17.50	17.59	17.67	17.78	17.97	18.46
48 large banks	19.54	18.64	18.42	18.88	19.01	19.36	19.82
Other banks	17.54	17.46	17.55	17.59	17.63	17.77	17.07

1/ The approximate compounded annual interest rate on each loan is calculated from survey data on the stated rate and other terms of the loan; then, in computing the average of these approximate effective rates, each loan is weighted by its dollar amount.

2/ The average interest rate calculation for the $50-99 thousand category excludes one outlying loan record.

(Continued)

(Continued)

Note: The survey of terms of bank lending is taken of about 340 banks selected to represent all sizes of banks. The sample data are collected over one business week and used to estimate lending terms at all insured commercial banks. Short-term loans have original maturities of less than one year, and long-term loans have maturities of one year or more. Construction and land development loans include both unsecured and loans secured by real estate. Thus, some of the construction and land development loans would be reported on the statement of condition as real estate loans and the remainder as business loans. As of 12/31/80, average domestic assets of 48 large banks were $11.4 billion and assets of the smallest of these banks were $2.3 billion. For all insured banks, total domestic assets averaged $105.8 million.

The survey of terms of bank lending to farmers covers about 250 banks selected to represent all sizes of banks. The sample data are collected over one business week and used to estimate lending terms at all insured commercial banks. Loans secured by real estate, purchased loans, foreign loans, and loans of less than $1,000 are excluded from the survey.

pay for loans from one of their key credit sources. Rising interest rates have, however, imposed a substantial cash flow burden on many small businesses because of their heavy reliance on debt financing. This likely was reflected in the finding of the March 1981 Heller/Roper Small Business Barometer that almost 40 percent of the small businesses surveyed have put off modernization or expansion because of high interest rates; comparable information does not exist for large business, so it is impossible to gauge the relative severity for small firms.

Problems of credit availability do not appear to have worsened markedly for small businesses this year. Forty-five percent of the respondents to the July 1981 NFIB survey described themselves as a regular borrower; only one fourth of these reported that money was harder to get than three months earlier. This proportion was about the same as in the April 1981 survey.

Inflation

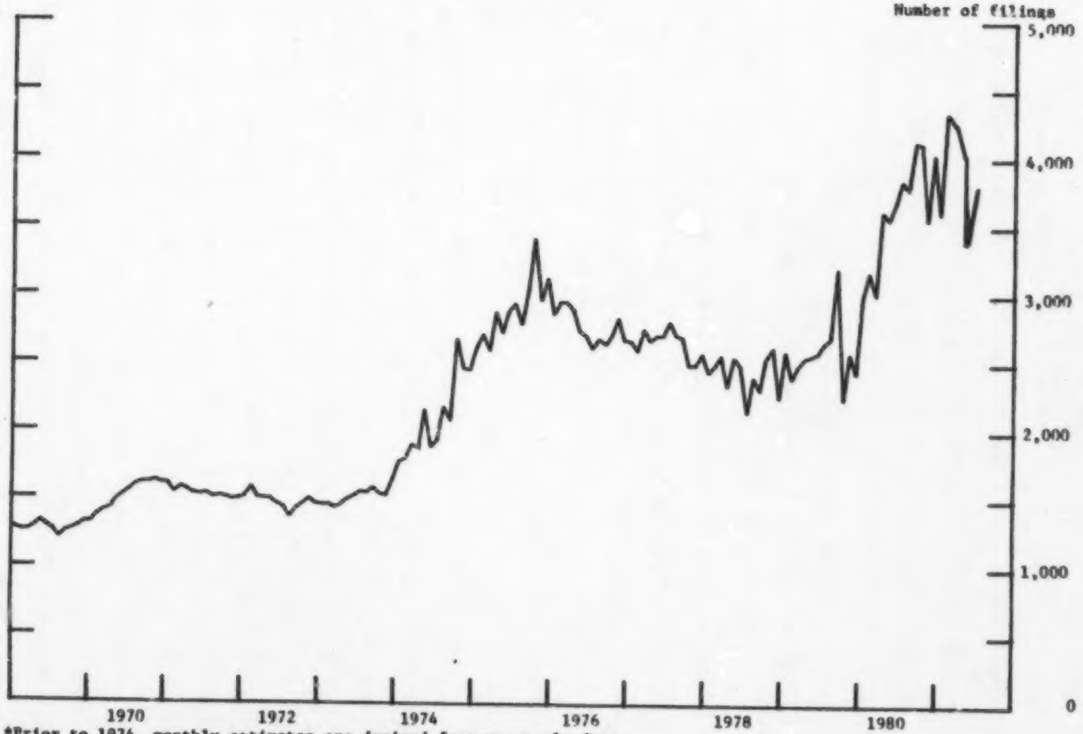
High interest rates are not the only factor creating stresses for small businesses. Many of the troubles confronting small businesses are directly or indirectly the product of an escalating inflation. Indeed, from 1973 until the second quarter of 1981, when there were indications that the rate of inflation might be slowing, the NFIB survey respondents cited inflation most frequently as the single most important problem facing their business. Interest rates and financing replaced taxes as the second most often cited problem only in recent quarters and replaced inflation as the most frequently cited problem in the second quarter of 1981. While the House Report respondents indicated that inflation was second to financing and interest rates as the most important problem facing the business at the actual time of their survey in April 1980 (when interest rates had just risen unusually rapidly), the most pressing problem cited for the near term was that the business believed it would not be able to pass through added costs to customers and still remain competitive. The White House Commission Report also stressed the importance of reducing inflation as a major objective for small business.

Inflation affects small businesses in several ways. Frequent and variable price changes make business planning difficult. Increases in input prices and wage rates result in a squeeze on cash flow if the business operates in an environment in which competitive pressures or sluggish demand prevent it from passing along the entire increases to its customers. To cover cash needs, businesses are forced to borrow more--and at high interest rates that themselves reflect inflation expectations and the effects of monetary restraint required to damp inflation forces. Some businesses have found that they cannot continue to cope with the strains created by inflation.

Bankruptcy

The substantial increase in bankruptcy filings since the end of 1979 (see chart on page 46) is an indicator of the difficulties experienced by small business. Business bankruptcies, which ranged between 2100 to 3200 on a seasonally adjusted monthly average basis from 1976 through 1979, have been running between 3000 and 4300 since the beginning of 1980. The interpretation of these numbers is unclear, however, since they reflect not only the economic conditions but also the revision of the Federal Bankruptcy Code that took effect in October 1979 as a result of the passage of the Bankruptcy Reform Act of 1978. Changes in the code have made filing of bankruptcy less onerous and have provided particular relief to eligible sole proprietorships. They are permitted to file under Chapter 13 which allows them to retain their assets as long as they are regularly repaying debt. If the proportion of businesses continuing in operation, rather than liquidating, after the filing

BUSINESS BANKRUPTCIES
(seasonally adjusted)



*Prior to 1974, monthly estimates are derived from quarterly data.
Source: Administrative Office of the U.S. Courts and Federal Reserve.
Latest data plotted: June 1981.

of bankruptcy has risen as intended under the new code, the increased number of filings may not be as serious as it appears.

Federal Reserve Board Actions

The Federal Reserve is pursuing its efforts to understand and deal with the particular financial problems of small business. As a matter of continuing policy, the Board encourages commercial banks to take into consideration the special needs of their small business customers. Also, each of the Federal Reserve Banks has recently appointed a Community Affairs Officer who serves as a point of contact and information exchange on issues and problems that may be of special concern in the local area, including those related to small businesses. The Board, in conjunction with an interagency task force on small business finance, has underway a project specifically focusing on the financing needs of small businesses. An important part of the project is an interview survey of commercial bank small-business lending practices at a small sample of banks throughout the country. The results of the survey will be available early next year and should yield further insights into the impact of credit conditions on small businesses.

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Senator D'AMATO. The next witness will be Dr. Alan Greenspan. First, I ask at this time that the testimony of Mr. Robert Georgine, president of the building and construction trades union, be submitted into the record in its entirety. Mr. Georgine was unable to leave here today.

[The prepared statement of Mr. Georgine follows:]

STATEMENT OF ROBERT A. GEORGINE, PRESIDENT
BUILDING AND CONSTRUCTION TRADES DEPARTMENT, AFL-CIO
Before the
Senate Committee on Small Business
September 23, 1981

On behalf of the AFL-CIO Building and Construction Trades Department, I would like to thank you, Mr. Chairman, for this opportunity to express our serious concern with the destructively high interest rates resulting from the Federal Reserve Board's tight money policy the Administration supports.

As a policy to reduce inflation, tight money reduces the demand for goods and services and raises unemployment of humans and machines. Experience demonstrates that the costs of lost output and income, and foregone savings and capital formation are socially unacceptable and economically inefficient. The economy is left with deteriorated, outmoded and inadequated plants, equipment, and housing that only invites a new round of inflation.

Reducing the pace of economic activity to a crawl and throwing millions of people out of work for an extended period of time is a self-defeating approach to reducing inflation.

Unfortunately, we in the building trades have first-hand experience with the suffering caused by high interest rates. Construction workers are the cannon fodder in the misguided campaign to reduce inflation by tightening up the supply of money and credit.

High interest rates are destroying the construction industry. According to Dun and Bradstreet, for example, the number of construction industry bankruptcies rose 480 from 463 in the first quarter of 1980 to 685 in the first quarter of this year. The reduced level of construction activity has resulted in unemployment for construction workers. In August, the unemployment rate for construction workers was 16.7 percent. This was more than double the 7.2 percent rate for the entire labor force. The 881,000 unemployed construction workers account for more than 11 percent of the total of 7.7 million unemployed workers.

Industries related to construction are also thrown into reverse. The industrial production index for the construction supplies industry declined 3.7% between January and August of this year. As a result, unemployment in construction-related industries has increased.

Both construction and construction-related industries play a leading role in determining the course of the overall economy. Because these industries produce long-term investment goods, the income of lenders involved has a multiplier effect in creating demand for consumer goods and services. Therefore, the economy will stagnate until interest rates decline and construction activity picks up.

As interest rates rise and the demand for investment and consumer goods falls, the rate at which capacity is used declines from its most efficient level. Thus, the unit costs of production are increased, and instead of reducing inflation, interest rates add to inflation.

The low rate at which manufacturing capacity is used -- which is now at 79% -- adds to inflation in another way. Unused capacity provides little incentive for firms to pay exorbitant interest rates in order to construct new plants or install additional equipment. This failure to invest retards long-term productivity growth which, in turn, worsens cost pressures.

High interest rates also add directly to the costs of goods and services that require financing. The effects on the cost of housing are particularly acute. In August, the average effective commitment rate quoted by major lenders for the purchase of newly-built single-family homes was 17.27 percent. (These are homes with a 75 percent loan-to-price ratio and a 25 year term to maturity.) This was 4.75 percentage points higher than a year earlier, and 6.02 percentage points higher than the average rate of 11.2 percent of two years ago.

Reflecting the squeeze in mortgage markets, the government recently raised its ceiling rate on FHA insured and VA guaranteed loans from 16½ to 17½ percent.

Moreover, the prospects for moderation in mortgage rates are poor. Recent events indicate that we will see higher and higher mortgage interest rates. At the Federal National Mortgage Association's latest auction of four-month commitments to buy home loans, yields on government insured or guaranteed loans hit an all-time record of 18.736 percent. These yields are an indication of the expected future trends of interest rates.

In addition to raising the monthly payment for home purchasers, high interest rates add to inflation by cutting back the supply of new housing -- which also contributes to inflation

Housing is historically one of the first industries to feel the effects of tight money. As credit is curtailed and interest rates soar, housing starts are choked off.

An estimated 2.5 million new housing units are required each year to meet housing needs generated by demographic trends, replacement needs and other factors. But, in August of this year, new housing starts were at the severely depressed annual rate of 937,000. This rate is 27 percent below the 1980 total of 1.3 million units, and 46 percent below the 1979 total of 1.7 million units. Moreover, it represents a 10.7 percent decline from the July painfully depressed rate of 1,049,000.

Furthermore, building permits declined again in August, to an annual rate of 863,000 from the July rate of 913,000. This is glaring evidence that the stifling effects of high interest rates will continue to depress the housing industry during ensuing months.

Sales data provide another indicator of the state of the housing industry. Here, too, we find the tell-tale tracks of high interest rates. At a seasonally adjusted annual rate of 420,000, new home sales were down 21 percent in July from last year's already depressed level.

The sales of existing homes are also in a decline. In July, existing home sales registered an annual rate of 2.5 million, compared with totals of 3.7 million in 1979 and 2.9 million in 1980.

With mortgage rates above 17 percent, the housing industry appears likely to remain depressed throughout the year. This will add to the inflationary pressures created by the shortfall in housing production over the past several years.

The combined effects of higher home prices and rising interest rates on the affordability of housing were traced in a recent study prepared by the National Association of Home Builders (NAHB). They point out that families are caught in a price-interest rate squeeze. With high interest rates, home prices may moderate somewhat because of a decline in sales. But, because of the larger interest rate payments, monthly payments remain high. If rates drop, many people will rush into the market, which drives up prices and monthly payments.

The Home Builder's study uses the average contract interest rate of 15 percent for mid-year 1981, and the median sales price of $70,000. The average loan-to-value ratio was 78 percent, and the average mortgage length was 29 years. Including principal, interest, real estate taxes, insurance, maintenance and utilities, the average monthly payment for the median-priced house was $957.67 in mid-year 1981. This is an astounding 23.7 percent increase over 1980.

These appalling increases in interest rates and sales prices have priced most families out of the market. A conventional rule of thumb is that income should be at least four times housing expenses. Thus, a family would have to earn nearly $46,000 to be able to afford a median-priced home under current conditions. But median family income was only $23,500.00. In fact, only 11.2 percent of all families in the nation earn enough to afford a median-priced home, a drastic decline from 1971 when 45 percent of families could afford a median-priced home.

With record high interest rates, lenders have liberalized their rules. It is now usual for buyers to have total housing expenses equaling one-third of gross income. Even under these more lenient standards, only 23 percent of families can afford the median-priced home in 1981, compared with 62 percent in 1971.

In addition to pricing people out of the market, high interest rates have a devastating effect upon traditional mortgage lenders. Savings and loan associations are competing for short-term funds by paying money market rates, while their portfolios are dominated by long-term low-yielding assets. As a result, many S & L's are suffering huge losses. This has produced a massive merger trend in the savings and loan industry. Through August of this year, there were 125 S & L mergers, compared with 109 in all of 1980. According to the Federal Home Loan Bank Board, there were only 38 S & L mergers in 1979.

In order to improve the health of the savings and loan industry, several financial innovations have been introduced. But the rhetoric of letting the market determine rates is belied by the fact that the Fed effectively determines rates through its high interest rate policy. In order to stem the outflow of funds from S & L's to higher-yielding money market instruments, S & L's were allowed to offer money market rates. This raised the cost of their funds dramatically.

Lenders were allowed to offer adjustable rate mortgages -- in the belief that this would prevent financial difficulties and keep funds available for housing when interest rates soar. But those countries with adjustable rate mortgages have been unable to avoid downturns in housing when money became tight and interest rates rose.

For example, Canada and the United Kingdom both have made widespread use of adjustable rate mortgages. But their housing industries have fluctuated with as much volatility as our own. Between the good housing year of 1978 and the depressed year of 1980, for example, new housing starts declined by 42 percent in the U.K. and 30 percent in Canada. In the U.S., the comparable decline was 36 percent.

Adjustable rate mortgages don't solve the problem created by high interest rates. Even though rates may vary over the life of a loan, the initial rate is set by lenders in accordance with their cost of funds. If they are paying high interest rates on the funds they raise, they're going to charge a high initial rate on the money they lend. And if people are priced out of the market, as under current conditions, they're not going to buy houses. Whether or not a savings and loan can offer an adjustable rate mortgage is irrelevant.

The most recent gimmick designed to assist housing is the so-called "All Savers" certificate. But savings and loans are allowed to use the funds to make home improvement loans, second mortgages, or purchase secondary mortgage market securities. In fact, the Federal National Mortgage Association just announced it will issue a special one-year security that banks and S & L's can buy with "All Savers" proceeds. Fannie Mae will use much of the money it raises this way to finance its existing mortgage portfolio, on which it is suffering losses. Very little of this money is likely to be used to buy new mortgages.

This supports our fear that the depressed housing industry isn't likely to get much help from the All Savers certificate. Furthermore, only those in tax brackets of at least 30 percent will find it advantageous to buy these certificates. For a married couple with two children to benefit from this certificate in 1982 they would have to earn more than $44,000, using standard assumptions regarding tax deductions.

Therefore, it is clear that the All Savers certificate is primarily a subsidy for lending institutions and the wealthy. While it represents a departure from free-market rhetoric, it is a departure which won't help the construction industry.

In another development, the Federal Home Loan Bank Board is going to propose legislation that would remove virtually all portfolio restrictions on S & L's. They would be allowed to make general commercial loans without asset limitation and to accept corporate demand deposits. As a result, S & L's will no longer be specialized housing lenders. While this may improve S & L profits, it will reduce the availability of funds for housing.

These maneuvers will radically restructure financial institutions and markets, but it doesn't appear that the health of the housing industry will be improved by these actions.

Other sectors that affect our members have also been devastated by high interest rates. In particular, public construction has stagnated for the past several years. In 1979 and 1980, the annual physical volume of public construction activity was between 7 and 8 percent below the level in 1978. During the first quarter of this year, a surge in highway construction resulted in a temporary recovery. But in the second quarter of 1981, the seasonally adjusted volume of new public construction put in place was 15½ percent below the level in 1978.

The combined effects of high interest rates and the Reagan Administration's massive income tax cuts have destroyed the market for state and local bonds. The tax reductions on high salaries, the availability of such other tax-exempt investments as the All Savers certificate, the expansion of individual retirement accounts, and the drastic reduction in estate taxes have reduced the market for tax-exempt municipal bonds.

The squeeze of municipal bond markets comes at a time when the administration's budget and tax cuts are causing state and local revenues to decline. Budget reductions reduced their direct grant aid, while federal income tax cuts reduced the states' revenue because their tax structures are often linked to that of the federal government. Thus, the Reagan program increased state and local borrowing needs, while making it more difficult for them to borrow.

Even if buyers can be found for their securities, state and local government officials are hesitant to commit themselves to long-term debt at rates exceeding 13 percent. Local governments have two alternatives: (1) They can borrow short-term at high money market rates and refinance later when bond yields decline, or (2) they can defer needed construction and maintenance. These deferrals reduce needed public services and cause additional job losses in the construction industry.

Tight money high interest rate policies also have a disproportionately harmful, job-destroying effect on other interest rate sensitive economic activities, such as auto sales, small businesses and family farmers. Furthermore, not all regions and income levels are equally affected.

Those who are paid interest prosper during periods of high interest rates. The rise in interest rates has coincided with a trend towards greater inequity in the distribution of income. Between 1968 and 1980, the triple-A corporate bond rate rose from 6.2 percent to 11.9 percent, and interest income as a percent of personal income rose from 7.7 percent to 11.9 percent. During the same period, the income share of the top 40 percent of American families increased by 1.7 percent to 65.9 percent of total family income in 1980. That means about $40 billion of the current annual national total of personal income was transferred from the bottom three-fifths to the top two-fifths of American families.

The only possible conclusion is that the Federal Reserve's policy of tightening up the money supply to control inflation is both ineffective and inequitable.

It is ineffective because the resultant high interest rates add to inflation both directly and indirectly. The cost of goods and services that must be financed rises as interest expenses are directly rolled into process. The skyrocketing cost of purchasing a home is perhaps the most striking example of this process. Because high interest rates discourage demand, businesses can't operate at levels of peak efficiency. This increases the cost of production. In addition, low capacity utilization rates, in combination with high interest rates, discourage investment. This retards productivity growth, adding to cost pressures.

Interest on the Federal debt is also the fastest rising part of the Federal budget, increasing by an estimated 32 percent during the 12 months ending June 1981. This causes heavy Federal borrowing that raises interest rates even higher.

Tight money is inequitable because it affects some industries, regions and individuals more than others. The construction industry, thrift institutions, states and local governments, small business, family farmers and auto sales are examples of sectors that have endured an unfair share of the suffering. Yet affluent individuals and rich firms have fared relatively well in spite of high interest rates. This is illustrated by the increased inequity in the distribution of income, the bidding of funds for many types of unproductive activities and the massive merger movement.

The joint Reagan Administration/Federal Reserve policy of slowing down the money supply must be abandoned. We should turn away from the disastrous reliance on tight money to fight inflation. Because tight money results in rationing credit through high interest rates, thereby often favoring nonproductive uses of credit, the Fed should use selective credit controls to channel credit for productive purposes, such as home mortgages; new residential, industrial and commercial construction; farming; financing of capital equipment; heavy equipment; cars and trucks; and industrial and state/local government bonds. By making credit less accessible for non-productive uses, interest rates for productive uses would tend to decline.

Experience both here and abroad demonstrates that credit controls provide a viable alternative to slowing down the money supply. The brief implementation of controls in 1980 proved helpful in rapidly bringing down interest rates. As a result, the decline in home building and general economic activity was reversed. Japan uses selective credit regulation to help keep inflation and unemployment at levels well below those of the United States. France's more formal structure of credit controls helped it to modernize its industrial base and increase its exports.

The Credit Control Act of 1969 provides the authority to use flexible credit controls as a supplement to general monetary policy. The AFL-CIO strongly supports making this authority permanent before its scheduled expiration in June, 1982, and using it now to bring down interest rates and revive key sectors of the economy.

STATEMENT OF DR. ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC., NEW YORK, N.Y.

Dr. **GREENSPAN**. I am delighted to be here, Mr. Chairman. I regret that I am not able to hear Bob Georgine, whom I always find rather fascinating. However, I will not say that I can substitute for him or take a point of view similar to his since I suspect that is highly unlikely.

What I should like to do is address the general economy, specifically with respect to interest rates. Then I will focus on specific areas which are of interest to you during the time you have for questions.

The persistently high level of interest rates seems finally to be unraveling the economy. The increasing evidence that the economy is slipping, albeit modestly, follows a period of remarkable stability in the face of historically high and rising rates.

Between January and August, for example, total industrial activity showed virtually no change and very little fluctuation. However, underlying this seeming state of economic tranquility were divergent developments pulling the economy in several directions.

A great deal has been conjectured about the adjustments the economy has been able to make toward living with higher interest rates. It appears, however, that the major reason why activity has been able to hold up under the burden of ever-increasing rates is that the capital goods markets have somehow continued to expand.

The underlying strength of demand for capital goods appears to flow mainly from a decade of inadequate investment. Prospective rates of return on investment for replacement have been rising as the underlying capital stock both continued to age normally and, in addition, has become increasingly obsolete under the impact of large changes in relative input prices, especially oil.

Replacing a 2-year-old piece of equipment with the newest technology would yield virtually zero rate of return. However, replacing a 50-year-old facility would in general be perceived of as highly profitable. Furthermore, the new tax bill has engendered an additional block of significant investment incentives.

The rise in prospective rates of return thus has partly offset the parallel rise in interest rates. As a result, it appears as if capital investment has become relatively less responsive to the rise in interest rates than it did in the past.

However, although the data are rather scanty, the level of capital investment actually seems to have been held back significantly by the rise in interest rates and the consequent increase in hurdle rates return, that is, the minimum rates of return required for business to authorize prospective capital expenditures.

Currently, signs are accumulating that the effects of the high level of interest rates are finally beginning to outweigh the rise in prospective rates of return. The influx of new orders in recent weeks seem to be inadequate to sustain current levels of industrial activity and employment.

Although initial claims for unemployment insurance fell back a bit last week following increases through early September, it is likely that incomplete tabulations associated with Labor Day weekend rather than improved economy are the cause.

On the surface, the weakness that has emerged in economic activity in recent weeks cannot lead to a free fall. Housing clearly is close to or at record lows, and interest sensitive consumer purchases have already been abnormally depressed.

Hence, even if weakness develops now in capital goods as well, it should not set off the traditional sequence of sharp inventory liquidation, plummeting housing, and sharply rising unemployment which characterizes a steep recession, at least as long as the financial system remains essentially intact.

Our financial institutions have become increasingly more brittle during the post-World War II decades, and espcially so in the past decade. The process still has been gradual, and predictions of imminent financial collapse throughout the period have been sufficiently numerous to now be listened to like the boy who cried wolf.

Indeed, what evidence we have suggests a remarkable ability at self-restoration of our financial structure both domestically and worldwide. As a consequence, at any moment in time, the probability that the financial system will actually crack, bringing the economy down with it, is never large. Hence, the average forecaster's day-by-day predictions never embody those catastrophic scenarios.

It is nonetheless becoming clear that at current levels of interest rates, the risks of a breakdown while still small no longer are insignificant. One is hard-pressed to remember that the huge below-market rate pool of financial resources represented by the possibility of borrowing against life insurance policies will remain untapped much longer.

Nor does one feel comfortable with the $200 billion in 5.2-percent passbook accounts, soon to be 6 percent, and the 7.5-percent small CD's in savings and loans. If these funds and the comparable below-market interest rate deposits in smaller commercial banks are converted to market rates, which they eventually must be, the impact on earnings and on the viability of a large number of institutions could be quite devastating.

We thus should not be lulled into the mistaken belief that somehow our economy can adjust to current levels of interest rates. It cannot. Therefore, it is critically important that we move to bring interest rates down. The question, however, is how. There is as much danger in doing the wrong thing as in doing nothing.

In assessing what viable options we have for getting out of the current situation, we must ask how did interest rates become so high in the first place.

Prior to 1979, inflation premiums embodied in long-term interest rates reflected the notion that the American economy was, by its institutional nature, insulated from inflation. While inflation periodically surfaced, until very recently, this always was presumed to be associated with war or its immediate aftermath.

In fact, the price level in 1940 was actually a shade lower than in the year 1800. After brief episodes immediately following World War II and the Korean war, inflation came down and had virtually disappeared by the early sixties.

Price controls were imposed by President Nixon in mid-1979 when inflation was raging at the presumably intolerable rate of 5 percent. U.S. Treasury issues never exceeded a yield of 9 percent until 1979, and prior to the late sixties, rarely exceeded 5 percent.

Since the real rate of return on riskless, that is Government issues, appeared to fluctuate between 2.5 percent and 3 percent, the inflation premium embodied in long-term interest rates averaged 4 percent or less throughout the period, even when inflation temporarily spurted in the midseventies. In effect, the markets were saying that the average expected inflation rate over the full 10-year maturity of a noncallable U.S. Treasury bond was approximately 4 percent.

Since the presumed expectation of inflation near term is well in excess of 4 percent, the implicit long-term inflation rate in the latter part of maturity was well under 4 percent. In short, until relatively recently, the markets have always been saying that despite whatever adverse inflation expectations hovered right in front of us, over the longer term one could presume that inflation would virtually disappear.

That point of view began to change in 1977 when, after a prolonged reduction in the rate of inflation from late 1974 to early 1977, the decline seemed to stall out and, in fact, showed evidence of reversing.

The benevolent view that the United States was essentially insulated from long-term inflationary pressures finally came to an end with the publication of President Carter's budget in January 1980, which he was forced to withdraw for a new budget shortly thereafter.

With relatively minor changes in inflation projections and unemployment, the fiscal 1984 outlay estimate made in January 1980 was $165 billion above that made in January 1979, just 1 year earlier. Compounded over a 10-year period, the changes in interest rates implied an upward revision of the projected 1990 price level which amounted to approximately 50 percent.

The markets reacted to what appeared to be conclusive evidence that spending was out of control and that the United States henceforth would be inflation prone. As a consequence, long-term interest rates moved to progressively high new ground.

The key questions now are: Where is the upper limit, if any, and, to what extent has the sharp rise in nominal interest rates been caused solely by increased inflation expectations, which of course were reversible, or by a change in real underlying rates and an addition to risk premiums as well?

There is of course no question that the short-term rates of 16 percent or higher are significantly above the short-term inflation rate and considerably above historic norms. There is little evidence, however, that such is the case for longer term rates. It is there where the major interest making forces currently reside.

Reaching back into history, one is hard pressed to find government yields in the major financial centers, either United States or British, exceeding 4.5 percent for any significant period of time. In fact, going back as far as the early 18th century, yields on British consuls moved above 5 percent only once, in 1784.

In short, there is no historic period anywhere which suggests real rates of return on Government issues of much more than 3 percent, and rarely ever more than 5 percent. While theoretically risk can be a factor, it cannot account for as much as 1 percentage point. Thus, today's 14-percent-plus U.S. Treasury yields have to be composed almost wholly of inflation premiums, that is of expectations of inflation over the longer run.

While such premiums have risen and fallen during the past year, they have continued to reflect an expected average inflation of 10 percent or more for the next decade, a forecast which if not significantly lowered suggests very perilous times ahead for the American economy. It is important to recognize that while a psychological statistic, it is a real number based regrettably to date on rational perceptions.

This inflation premium will not disappear as a consequence of eloquent utterances of optimism by the administration or by pledges of lowered money supply targets by the Federal Reserve. The markets are skeptical and deservedly so, and will react, in my judgment, only to hard evidence that Federal expenditure and credit growth will slow from the path which it has currently been on. Promises are worth little to the markets.

However, changes in legislation which significantly alter the implied proportion of Federal borrowing, both on budget and off, to aggregate savings almost surely will alter the long-term inflation outlook and, by definition, reduce inflation premiums markedly for long-term bonds. This, in turn, would trigger a heavy refunding of short-term liabilities, thereby bringing short-term interest rates down as well.

We have to move in that direction. I think the President's policy is largely directed in that direction. I myself wish there were alternate policies. I have heard none.

Thank you, Mr. Chairman.

Senator D'AMATO. Thank you very much, Dr. Greenspan.

That is a rather somber prognostication. One, I think, that many people feel is probably more accurate than we would like to admit.

Given the world of socioeconomics and politics, what would you suggest as the kind of action that realistically might be undertaken, given the constraints within which we live today?

Dr. **Greenspan**. Mr. Chairman, if you had asked me that question back in January, I would have said that the possibility of Congress, specifically the Senate, doing what it did over the next several months was outside the realm of realism.

Something is changing in this country. I think what it is is a general awareness that inflation is utterly intolerable to our society, that we cannot survive it.

The result of that is a fairly marked change in the underlying structure of our political institutions. I interpret the word realism as meaning political realism in a much looser sense than I would of, say, a year ago.

That realism requires that very substantial further cuts be made in the budget for fiscal year 1983 and 1984, and to the extent that cuts for those relatively nearby years require that the wedge be opened up further for fiscal 1982, that cuts in the year that is about to begin be made as well.

I myself do not believe that the actual budget deficit that materializes for fiscal year 1982 itself is as critical to the financial system as it is a symbol of where it is going for the long-term.

There is nothing that I know of which says you cannot readily finance, say, an additional $5 or $10 billion next year, but it is not the supply in the short run of Government securities which is keeping interest rates high. It is the expectation that deficits are $120, $150, or $200 billion in the latter part of the 1980's that is causing the problems today.

The fiscal 1982 numbers are relevant only to the extent, in my judgment, that they affect people's perceptions in the financial markets about the latter half of the 1980's.

Senator D'Amato. Senator Nunn?

Senator **Nunn**. Thank you, Mr. Chairman.

Dr. Greenspan, do you believe that we can largely exempt defense, social security, and interest on the debt and still make the kind of cuts, the magnitude of cuts, that is being talked about?

Dr. **Greenspan**. No; I do not, sir.

Senator **Nunn**. What magnitude of cuts do you think are necessary in the 1982, 1983. and 1984 timeframe?

Dr. **Greenspan**. While it would be extraordinarily useful to have the budget in balance by fiscal 1984, it is not necessary at this stage to do so if one's purpose is to lower interest rates.

The financial markets, as I read them at this time, have discounted a budget deficit of somewhere between $70 and $80 billion for fiscal 1984. If those numbers turn out to be $40 billion or $35 billion or $30 billion, interest rates will come down very significantly from current levels.

Therefore, I would say that the type of budget cuts you would probably try to move toward are the ones which in a current analysis today would get you, say, down to a deficit of $20 billion, meaning if you shoot for $20 billion, you will get $40 billion.

Depending on congressional budget offices or the Senate budget committee's estimates that you employ, whatever is required to arithmetically get the budget deficit on paper, meaning in a projection, down to $20 billion is the type of cut I would suggest would be sufficient to bring down the level of interest rates.

They may not be necessary, meaning that something slightly less than that may actually after the fact have turned out to have been enough, but we have procrastinated so long by cutting away at the margin, so to speak, that it is essential at this point to take actions which will once and for all restore fiscal balance to this country.

The cuts which have been made to date are very useful and very important, but we are not there yet. I think we can achieve it.

Senator **Nunn**. Whose figures do you believe if you are a Member of the Senate now? As you are well aware, the figures vary widely.

You made reference to the CBO figures. Would you be guided by the CBO figures or by the administration figures if you were trying to arrive at a logical position on budget cuts?

Dr. **Greenspan**. I would assume that in both cases their revenue estimates were too high.

It is not that either set of numbers is unrealistic, but I think both are a shade above the more likely outcomes. Because there is more danger in making a mistake by not cutting enough than by cutting too much, I would suggest you err on the side of conservatism even when the forecast may be modestly more conservative than you would like.

As you well know, Senator, there is a tendency in Government to seek those forecasts which make political decisions easiest. I am afraid that succumbing to that will make the political decisions that have to be made 2 years from today or later far more difficult than they need be.

Senator **Nunn**. I know you are concerned about foreign policy, effects on negotiations, effects on the Middle East, and so forth. Would you say that defense cuts should be of the magnitude that would take the President's defense budget below President Carter's defense budget?

Dr. **Greenspan**. Senator, I am scarcely one to suggest to you what has been going on in President Carter's budget, but looking at it as an amateur from the outside, having watched those budgets evolve, it struck me that President Carter's last defense budget had a certain Reaganesque character to it as he was leaving office which did not prevail in earlier budgets.

I would be more inclined to think in terms of the Carter budget, the one produced in January 1980, not in January 1981, and, in that sense, I think that the concern about whether or not the President's budget is above Carter's January 1981 budget should not be a consideration.

The real issue is what are the national security requirements that are required to be maintained. The last thing I can conceive of which can be relevant to that discussion is whether the number is higher or lower than the number which President Carter put out.

Senator **Nunn**. I would agree with you on that. The problem is there is a backlog of needs that goes back 15 years, and none of the numbers, even the President's highest numbers, satisfies those needs. When people talk about not needing to talk numbers and just needing to talk needs, if you talk needs, you are talking about a 10- or 15-percent real growth rate, not 7 percent.

The President's defense numbers do not come anywhere near buying his own program. That is the sad thing. I keep hearing people say, "Let us not talk numbers." However, what I am saying is the shopping list of needs, if you carry out your strategy and you carry out your commitments, is so long that none of the numbers even at the highest level will fulfill those needs.

That does not mean to me that we ought to do it all at once. I think that it is as prudent to catch up over 10 or 15 years. I do not think it is prudent to try to catch up all at once. I think that is a foolish way and a very inefficient way, but none of the numbers, even the highest numbers, come anywhere near meeting the needs.

Dr. **Greenspan**. I am aware of that, Senator. The only thing I can say in response to that is that I have always considered that one of the issues critical to our national security is the sustaining of our industrial structure.

I do not think it is an accident that no matter what the Russians do with respect to strategic capability they never quite get up to where we are technologically. What we are looking at is the fallout from an extraordinarily sophisticated economy which we have been able to put together under our system over the last several generations.

I do not know how one trades off the technological base against whether or not you put on another wing of F-16's but it is clear that that judgment has to be brought to bear because if, in effect, we do not at least keep an eye on our industrial structure and its vitality, we are going to find that we may resolve some of the short-term problems that regrettably occurred in our military preparedness shortfalls in recent years, but find that when we get into the 1990's, the forefront of our technological capabilities are beginning to fade. There are no budget numbers which can correct that.

Senator **D'Amato**. Senator, will you yield for a question?

Senator **Nunn**. Surely.

Senator **D'Amato**. Previously, Dr. Greenspan, Senator Baucus and Senator Huddleston addressed themselves to the question of various methods of dealing with the deficits in 1983 and 1984 and the question of possibly deferring some of the tax cuts or targeting them to certain conditions, possibly reduction of deficit or the achievement of certain spending levels.

What is your feeling in regard to that as a possibility? What effect would it have? Is it possible? Would you advise it if you had your choice?

Dr. **Greenspan**. I think it would be a mistake, Senator. We have to keep in mind the fact that high interest rates are a very serious problem in the country, and deficits do cause inflation, perhaps not them directly, but what creates the deficits ultimately does.

Nonetheless, that is not the only problem we have in our system. We have also over the years developed a tax system which, as we are now all acutely aware, tended to marginally depress incentives by creating a rise in effective taxation which came wholly as a result of people moving into higher brackets.

I do not agree 100 percent with the tax bill which you just passed, but I think it is an extraordinarily useful bill. It has very significant positive characteristics and essentially prevents further growth in the tax burden.

In my judgment, that issue has been solved. I would find it very regrettable if in order to pick up some short-term benefits, which would exist if you delayed the tax bill, we in fact used as our currency the solution to previous problems which we can now in a sense put aside.

We have got to get the deficit down, but it has to be done from the expenditure side.

Senator D'AMATO. You are saying it is the blood way, the hard way.

Dr. GREENSPAN. Yes, it is.

Senator D'AMATO. Thank you.

Senator NUNN. Dr. Greenspan, assume that the President was going to ask for $100 billion in cuts over the next 3 years, 1982, 1983, and 1984. I do not know what the number will be. Just assume that. You can take $90, $100 billion, or whatever.

Assume that because of many different considerations the Congress did not go along with anything like that magnitude of cuts. Let us assume the Congress went along with about 30 percent of those cuts. Therefore, you end up cutting the budget $35 billion instead of $100 billion.

Dr. GREENSPAN. Are you saying cumulative over the years, Senator?

Senator NUNN. Over the 3 years.

Dr. GREENSPAN. So there is effectively, say, $15 billion at the tailend?

Senator NUNN. Right.

Plugging that into your own projections, what effect do you think it will have on the economy under that scenario?

Dr. GREENSPAN. It will probably be a modest plus, but not enough to resolve what is a continuous state of deterioration that is going on. I think you have to do more.

Senator NUNN. If you assume that hypothetical, then under those conditions would you say we would be better off continuing the tax cut as it is, or would we be better off making some adjustments in the tax cut?

Dr. GREENSPAN. You are really asking me which of two diseases I would prefer to have.

Senator NUNN. I know, but that is what we face every day on votes.

Dr. GREENSPAN. I understand that.

Senator NUNN. I think that is what we are going to face within 2 months. He has not even proposed these to the Democratic leaders yet, and if the Republican leaders are not going along with it, you can bet your bottom dollar you are not going to get a majority.

Dr. GREENSPAN. That is a question which I would not answer now if the answer could be delayed for 2 months. The reason I say that is, as I mentioned in my opening remarks, the economy is beginning to show signs of weakening. How interest rates respond to that is going to be quite important to the answer to that particular question.

If you had to answer now, I probably would opt for saying do not move on the tax bill. Let it go, and hope that things will prevail on the expenditure side sufficiently to bring interest rates down enough to prevent the types of problems I was raising.

Senator NUNN. Then if we have to address the tax bill, address it late in the year or early next year?

Dr. GREENSPAN. Yes, sir.

Senator NUNN. Could it be that we might get into a recession serious enough that interest rates will automatically come down significantly in the short run, and at that stage, individual tax cuts will be essential to give the economy a boost?

Dr. GREENSPAN. I would say, yes, for interest rates coming down, but I would not want to argue that what we need is fiscal stimulus to respond to a recession.

Senator NUNN. I am describing what we have on the books. Keynesians describe the same thing we have been calling supplyside on the individual tax cuts as stimulus, and the supplysiders call it supplyside. However, whatever it is, it is an individual tax cut. It is the same thing we have been calling consumption oriented stimulus for 25 years. I do not think the fact that you change the label changes the nature of human behavior.

Dr. GREENSPAN. I fully agree, Senator.

Let us put it this way: If I were putting a Keynesian hat on, I would say it would be inappropriate to raise taxes. If I were putting on the other hats which I would tend to wear more readily, I would say I do not think raising taxes would make any sense anyway. I come out the same way.

Senator NUNN. Either way you would not try to roll back those tax cuts at this juncture?

Dr. GREENSPAN. That is correct.

Senator NUNN. What do you project as the real growth rate in 1982?

Dr. GREENSPAN. I think it is better described in terms of very little growth through the early spring. Then starting in the second half, if, as I expect, interest rates come down, somewhere in the area of 4 percent annual rate plus.

In other words, the second half of 1982 with a relatively modest decline in short-term interest rates and some decline in long term, could be a far superior performance than we have seen for quite a while.

Senator NUNN. Your projection would not be as high as the administration's 5.2 percent real growth figure for 1982?

Dr. GREENSPAN. No, I would not, sir.

Senator NUNN. You are somewhere around 3.5?

Dr. GREENSPAN. For the year as a whole, I am actually comparable to those numbers at something closer to 2 percent.

Senator NUNN. Two percent?

Dr. GREENSPAN. Yes, sir.

Senator NUNN. If we take your growth rate and then take the administration's other assumptions, based on the CBO figures this morning, admittedly rough, you're 3 percent below the administration's real growth projection. I am told by CBO cumulatively over 1982, 1983, and 1984 that a 1 percent real growth reduction amounts to about $33 billion increase in the deficit.

Dr. GREENSPAN. Yes. Actually, our forecast for 1983 and 1984 is a significant improvement, although we would track under the level of revenues of the administration and CBO pretty much throughout 1984.

Senator NUNN. Let me then confine it to 1982. They say $5 billion for each 1 percent in 1982. In other words, if you have 4.2 percent real growth instead of 5.2 percent, you have $5 billion less in revenue. Roughly speaking, I am told you can multiply that by three.

Your real growth level is 2 percent. Theirs is 5.2. You multiply that out times eight and you would get $15 billion less in revenue. That is using different assumptions.

Dr. GREENSPAN. That is pretty good. Our number is $22 billion.

Senator NUNN. That is pretty close.

The administration is now talking about $16 billion in budget cuts for 1982. Would you not have to add on another $22 billion to that in your figures in order to come anywhere close to the deficit projections that the administration is hoping for? Under your assumptions, would you not have to cut almost $40 billion out in 1982?

Dr. GREENSPAN. Yes. I think if you take the type of growth that I have in the forecast, the answer is that arithmetically that is correct.

However, I do not think that one needs to get a $42.5 billion deficit for interest rates to come down. The markets at this stage are already assuming a $70 billion deficit for fiscal 1982. If by some means the figure was, say, $55 or $50 billion, interest rates would be coming down.

Senator NUNN. If the markets are correct, we are going to continue to have the kind of markets we have now. That is if the deficit really is about $70 billion.

Dr. GREENSPAN. In an odd way, it is both good news and bad news, Senator. The fact that the markets are so skeptical and are, in fact, in my judgment, at least forecasting a state of affairs which is probably a shade on the unlikely side, meaning that it is more pessimistic than I think really is probably appropriate. Anything that the administration and the Congress do in the way of cutting into fiscal 1982 expenditures will be viewed, I think, rather positively by the markets.

Senator NUNN. Even if the adminstration at the same time is having to come down on their growth rate significantly?

Dr. GREENSPAN. Yes.

Senator NUNN. Thank you very much, Dr. Greenspan.

Dr. GREENSPAN. Thank you, Senator.

Senator D'AMATO. Dr. Greenspan, what you are saying then is in your anticipation we have seen the worst, that the markets have factored in all problems of unanticipated increases in the budget deficits, that the squeezing out of some of the economic forces that are taking place right now will lower the interest rates sometime in 1982?

Dr. GREENSPAN. In my judgment, Senator, the markets are assuming——

Senator D'AMATO. The worst?

Dr. GREENSPAN. No, I would not want to say the worst because I can, if you force me, create a general state of affairs which is worse than they are assuming. In other words, no matter how you look at it, fiscal 1982 outlay estimates adjusted for the level of economic activity, are unquestionably a major improvement over what the current services budget was.

It is conceivable as you go through the appropriations processes and supplemental appropriations and other unforseen events, or new legislation which fortunately we have not seen for quite a while, that, yes, I can create a scenario that the market has not yet anticipated.

However, in a realistic sense, most of the more pessimistic views of what is going to happen with respect to the budget process are already embodied in the level of interest rates.

Senator D'AMATO. Dr. Greenspan, I would like to thank you for your very thoughtful presentation.

Let me just close with one question. Supposing there is relatively no action, no reaction congressionally to the new requests for further budget curtailment, et cetera, and that the budget levels remain essentially the same in 1982, 1983, and 1984. What is your view then in terms of inflation and in terms of interest rates?

Dr. GREENSPAN. I think interest rates will stay up where they are because, in effect, that is what the markets are discounting. We will then begin to see significant financial erosion some time beginning in the spring of 1982, meaning that you will begin to see financial institutions both here and probably abroad running into far greater difficulties than we have seen in a very long period of time.

As I mentioned, I do not think we are about to see an actual financial break. That is an extremely unlikely event. However, as we get into the latter part of the 1982 period, we are going to see savings and loans in ever greater difficulty, smaller commercial banks which have balance sheets which look like savings and loans will also be in grave trouble.

We will find something we should have known for a long time. Unlike other countries, our economic and financial infrastructure is not capable of living with high interest rates. We have built up a system which presupposes and in fact requires that interest rates be low, and that the yield term is upward sloping, meaning short-term rates are lower than long-term rates, and that inflation is nominal. Without that, the system begins to shake and create very grave difficulties for us and for our economy.

Senator D'AMATO. Dr. Greenspan, thank you so very much for your testimony.

This committee stands recessed until 9:30 tomorrow morning.

[Whereupon, at 12:30 p.m., the committee recessed, to reconvene on Thursday, September 24, 1981, at 9:30 a.m.]

[The prepared statement of Dr. Greenspan follows:]

Excerpts from the Testimony of Alan Greenspan*

Before

The United States Senate
Committee on Small Business
September 23, 1981

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The persistently high level of interest rates seems finally to be unraveling the economy. The increasing evidence that the economy is slipping, albeit modestly, follows a period of remarkable stability in the face of historically high interest rates. Between January and August for example, total industrial activity (the best indicator this year of broad overall activity) showed virtually no change and very little fluctuation. However, underlying this seeming state of economic tranquility were divergent developments, pulling the economy in several directions. Rather than behaving like a car at rest, the economy has been more like a car caught in a snowbank spinning its wheels ineffectually in an endeavor to break out. The car is going nowhere, but rather than being at rest, it is straining its engine and fraying its tires.

A great deal has been conjectured about the adjustments the economy has been able to make toward living with higher interest rates. It appears, however, that the major reason why economic activity has been able to hold up under the burden of ever increasing interest rates is that the capital goods markets have somehow continued to expand.

The underlying strength of demand for capital goods appears to flow mainly from a decade of inadequate investment. Prospective rates of return on investment for replacement have been rising as the underlying capital stock both continued to age normally and, in addition, has become increasingly obsolete under the impact of large changes in relative input prices. Replacing a two year old piece of equipment with the newest technology is surely going to create virtually zero rate of return. Replacing 50 year old facilities would be perceived as highly profitable. Furthermore, the new tax bill has engendered an additional block of investment incentives. The rise in prospective rates of return thus, has partly offset the parallel rise in interest rates. As a result it appears as if capital investment has become relatively less responsive to the rise in interest rates than it did in the past. However, although the data are rather scanty, the level of capital investment actually seems to be held back significantly by the rise in interest rates and the consequent increase in hurdle rates of return (i.e. the minimum rates of return required for business to authorize prospective capital expenditures).

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Currently, signs are cumulating that the effects of the high level of interest rates are finally beginning to outweigh the rise in the prospective rates of return. The influx of new orders in recent weeks should be inadequate to sustain current levels of industrial activity and employment. Although initial claims for unemployment insurance fell back a little last week, following increases through early September, it is likely that incomplete tabulations associated with the Labor Day weekend, rather than an improved economy, are the cause.

On the surface, the weakness that has emerged in economic activity in recent weeks cannot lead to a free fall. Housing clearly is close to or at record lows, and interest sensitive consumer purchases have already been abnormally depressed. Hence, even if weakness develops now in capital goods as well, it should not set-off the traditional sequence of sharp inventory liquidation, plummeting housing, and sharply rising unemployment which characterizes a steep recession. At least as long as the financial system remains essentially intact.

Our financial institutions have become increasingly more brittle during the post World War II decades, and especially so in the past decade. The process still has been gradual, and predictions of imminent financial collapse throughout the period have been sufficiently numerous to now be listened to, like the boy who cried wolf. Indeed, what evidence we have suggests a remarkable ability at self-restoration of our financial structure both domestically and world-wide. As a consequence, at any moment in time the probability that the financial system will actually crack, bringing the economy down with it, is never large. Hence, the average forecaster's day-by-day projections never embody those catastrophic scenarios.

It is nonetheless becoming clear that at current levels of interest rates, the risks of a breakdown while still small, no longer are insignificant. One is hard-pressed to imagine that the huge low-cost pool of financial resources, represented by the possibility of borrowing against life insurance policies, will remain untapped much longer. Nor does one feel comfortable with the $200 billion in 5-1/2% passbook accounts and 7-1/2% small CDs in the savings and loans. If these funds, and the comparable below-market interest rate deposits in smaller commercial banks are converted to market rates, the impact on earnings and on the viability of a large number of institutions could be quite devastating.

We thus, should not be lulled into the mistaken belief that somehow our economy can adjust to current levels of interest rates. It cannot. Therefore, it is critically important that we move to bring interest rates down. The question, however, is how. There is as much danger in doing the wrong thing as in doing nothing.

In assessing what viable options we have for getting out of the current situation we must ask how did interest rates become so high in the first place. Prior to 1979, inflation premiums embodied in long-term interest rates reflected the notion that the American economy was, by its institutional nature, insulated from inflation. While inflation periodically surfaced, until very recently this always was presumed to be associated with war or its immediate aftermath. In fact, the price level in 1940 was actually a shade lower than in 1800. After brief episodes immediately following World War II and the Korean War, inflation came down and had virtually disappeared by the early 1960s. Price controls were imposed by President Nixon in mid-1971 when inflation was raging at the presumably intolerable rate of 5%. U.S. Treasury issues never exceeded a yield of 9% until 1979, and prior to the late 1960s, rarely exceeded 5%. Since the real rate of return on riskless, i.e., government issues appeared to fluctuate between 2-1/2% and 3%, the inflation premium embodied in long-term interest rates averaged 4% or less throughout the period, even when inflation temporarily

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spurted in the mid-1970s. The markets were in effect saying that the average expected inflation rate over the full ten-year maturity of a noncallable U.S. Treasury bond was approximately 4%. Since the presumed expectation of inflation near-term was well in excess of 4%, the implicit long-term inflation rate in the latter part of the maturity was well under 4%. In short, until relatively recently, the markets have always been saying that despite whatever adverse inflation expectations hovered right in front of us, over the longer term one could presume that inflation would virtually disappear.

That point of view began to change in 1977 when, after a prolonged reduction in the rate of inflation from late 1974 to early 1977, the decline seemed to stall out and, in fact, showed evidence of reversing. The benevolent view that the U.S. was essentially insulated from long-term inflationary pressures finally came to an end with the publication of President Carter's budget in January 1980 (which he was forced to withdraw for a new budget shortly thereafter). With relatively minor changes in inflation projections and unemployment, the fiscal 1984 outlay estimate made in January 1980 was $165 billion above that made in January 1979. Compounded over a ten-year period, the upward revision of the projected 1990 price level amounted to approximately 50%. The markets reacted to what appeared to be conclusive evidence that spending was out of control and that the U.S. henceforth would be inflation-prone.

As a consequence, long-term interest rates moved to progressively new high ground. The key questions now are, "Where is the upper limit, if any?", and, "To what extent has the sharp rise in nominal interest rates been caused solely by increased inflation expectations (which are reversible), or by a change in real underlying rates and an addition to risk premiums as well?". There is of course, no question that the short-term rates of 16% or higher are significantly above the short-term inflation rate and considerably above recent historic norms. There is little evidence however, that such is the case for long-term rates, and it is there where the major interest making forces preside. Reaching back into history one is hard-pressed to find government yields in the major financial centers, either U.S. or British, exceeding 4-1/2% for any significant period of time. In fact, going as far back as the early 18th Century, yields on British consols moved above 5% only once, in 1784, and they never reached that level in the U.S. In short, there is no historical period anywhere which suggests real rates of return on government issues of much more than 3% and rarely ever more than 5%. While theoretically risk can be a factor, it cannot account for as much as one percentage point. Thus, today's 14% plus U.S. Treasury yields have to be composed almost wholly of inflation premiums.

While such premiums have risen and fallen during the past year, they have continued to reflect an expected average inflation of 10% or more for the next decade, a forecast which, if not significantly lowered, suggests very perilous times ahead for the American economy. It is important to recognize that while a psychological statistic, it is a real number based on rational perceptions. This inflation premium will not disappear as a consequence of eloquent utterances of optimism by the administration, or of pledges of lowered money supply targets by the Federal Reserve. The markets are skeptical and deservedly so, and will react, in my judgment, only to hard evidence that federal expenditure and credit growth will slow. Promises are worth little. However, changes in legislation which significantly alter the implied proportion of federal borrowing (on budget and off) to aggregate savings almost surely will alter the long-term inflation outlook and, by definition, reduce inflation premiums markedly for long-term bonds. This in turn, will almost surely result in heavy refunding of short-term liabilities, thereby bringing short-term interest rates down as well.

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INTEREST RATES AND BUSINESS CREDIT NEEDS

THURSDAY, SEPTEMBER 24, 1981

U.S. Senate,
Committee on Small Business,
Washington, D.C.

The committee met, pursuant to notice, at 9:30 a.m., in room 424, Russell Senate Office Building, Hon. Lowell Weicker, Jr., chairman of the committee, presiding.

Present: Senators Weicker, Hayakawa, Nunn, and Dixon.

Also present: Robert J. Dotchin, staff director; James J. O'Connell, economist; G. Thomas Cator, minority economist; W. P. Goodwin, Jr., special minority counsel; and Margaret M. Broadbin, hearing clerk.

STATEMENT OF HON. LOWELL WEICKER, JR., A U.S. SENATOR FROM THE STATE OF CONNECTICUT, AND CHAIRMAN, COMMITTEE ON SMALL BUSINESS

Senator Weicker. Today this committee is continuing its hearings into the problem of high interest rates and business credit needs. Yesterday's hearings were very instructive to the committee. I know I speak for all our members when I say the high interest rates are clearly the nemesis of the U.S. economy.

Today we will hear from some of the affected sectors of the economy—labor, homebuilders, auto dealers, and farmers. Today we go from the niceties of the economic theory to the grim reality of bankruptcy, unemployment, and economic devastation.

Thousands of small businesses in America are going down the tubes because of high interest rates and bringing with them their workers and their communities. Companies that have been the mainstay of communities for generations are on the ropes now because of high interest rates.

We have had 11,000 bankruptcies in the first 8 months of 1981 alone—nearly 50 percent above last year.

Some can enjoy the luxury of sophistry on this issue. However, for labor, auto dealers, homebuilders, and farmers the future is now. They need relief from high interest rates, and they need it soon.

This economy is in very deep trouble, and staggering interest rates have made things worse.

I look forward to hearing from our witnesses today and very much appreciate their being with us today.

As our first witness, we have one of the truly great leaders of American labor, Mr. William Winpisinger, president of the International Association of Machinists, which union is certainly well-represented in the State of Connecticut, where the largest employer in the State is United Technologies.

I know that Mr. Winpisinger has long taken a continuing interest through Democratic and Republican administrations in the economy, particularly how it affects the working people of this country. I am delighted that he made this considerable effort to be with us this morning.

I welcome you to the committee.

STATEMENT OF WILLIAM W. WINPISINGER, INTERNATIONAL PRESIDENT, INTERNATIONAL ASSOCIATION OF MACHINISTS & AEROSPACE WORKERS, WASHINGTON, D.C., ACCOMPANIED BY RICHARD GREENWOOD, ASSISTANT TO MR. WINPISINGER, INTERNATIONAL ASSOCIATION OF MACHINISTS & AEROSPACE WORKERS

Mr. **Winpisinger**. Thank you very much, Senator.

It is equally a pleasure for us to have the opportunity. We appreciate the invitation.

I suspect that any statement I might make, up until the point you began to introduce me, would be simply to subscribe to the words you spoke so well with regard to the subject matter at hand.

I have submitted a statement. I doubt very frankly I could go through it word for word in 10 minutes. I think it might be appropriate to try to summarize and get what we feel might be the key points.

Let me introduce my colleague, Richard Greenwood, from my staff who assisted in the preparation of the statement that has been submitted.

Senator **Weicker**. Without objection, your entire prepared statement will be made a part of the hearing record at the completion of your oral presentation.

Mr. **Winpisinger**. Thank you.

Our union represents a very broad cross section of American workers, running from the extremely highly skilled journeymen and technicians in the aerospace complex across the whole face of heavy industry—mechanics of every type and semiskilled and unskilled workers as well in the industrial complex.

We just about cover the waterfront in that connection.

We think the kind of economic theory which is running amok in the country today is simply not the kind that is going to deliver America into the land of milk and honey.

We need to do something about the most nagging of the problems, which is the subject of your inquiry—high interest rates. We think they are high by one thing and one thing alone—the policy of the Federal Government. As long as the policy remains as it is, we do not see them abating.

I think it can fairly be said that they are artificially high because of that policy. They seem to be remaining high, even in violation of the noninterventionist creed of those currently running the show, to get back to some sort of pristine market system which does not seem to be operating at the moment.

We think the remedies thus far created to address the problem do not reach the cause. That is where I would like to focus for the few minutes that we have.

I think it is time that we recognize once and for all in the United States that we have a dual economy at work out here in the land.

It is dual because you have the multinational conglomerate giants, numbering the Fortune 500, and perhaps a few others similarly situated, who by their activities and by the concentrations of wealth and capital that have been created are insulated against any of the marketplace cures addressed to the problem.

They do not need to borrow. Interest rates could be 100 percent in the United States today, and it is not going to affect those large institutions who seem to be running the show and have the clout to continue to run it.

They simply borrow from each other and convert foreign holdings to cash, borrow abroad, and any number of other devices—even to the point of buying a cash cow if they run short in the market. They insulate themselves from the ravages of high interest rates.

Because we enact that kind of economic policy and it does not reach the culprits—which I call them, although I have to put that in quotes—you have small businessmen left to the mercy of the problem or the proposed solution.

What we really have is a small business community in this country which is really the private sector. The big guys I call the super economy, immunized from all of this. There are 700 to 800 firms, roughly, and 10 or 11 million employers, who are the private sector and who are out there competing and who are the victims of these kinds of economic policies.

To the extent that others insulate themselves, they simply visit more of the problem on the backs of small business.

For the most part, small business over the past decade or so has been the engine of jobs in this economy. Every time we injure further their ability to compete and remain in business, we are defeating the engine of jobs.

In sum, I guess I could say that when the name of the game becomes investing money in money, we are obviously not investing it in any form of productivity, any industries, or any of the so-called multiplier or ripple effects that it takes to create economic growth in this country.

Small business in every sense of the term is the victim of what we have done up to now.

I think we need some new approaches and new policies and perhaps even some new institutions and new tools to get at the root of the problem and do something meaningful about them.

I would just like to allude to those briefly and cap off my statement.

I think, among those, we need to look at a domestic investment production policy. We see such policy all the time abroad in other nations not similarly as afflicted as we are. That is primarily because they have the institutions of central banks which actually sit with the various industries and, in effect, as spokesmen for the Government, maybe arms-length removed. They are determining production policy in those industries in which investments will be made. Because they are a central bank, they make the necessary cash available.

I think we need an industrial development bank here which can serve the capital needs of small- and medium-sized businesses and do it on the basis of some national priorities, by industrial sectors and regions, selective allocations of credit, interest rate rollbacks, or freezes if we have to have them to get it started. International finance and foreign trade reforms have to be an essential part of it and an adoption of an economic and social policy that will restructure investment and production decisionmaking processes and induce corporate accountability to the American people and responsibility to those who work for them, for the communities in which they operate, and to the country as a whole.

I think we are probably at that crossroads in the development of our great society where we have to discard the free market mythology that blinds all of us to the realities of economic behavior and the specter of the economy.

We have been concerned about this for some time, as you pointed out early on. As a consequence of that, we have spent many months now constructing a proposal which we call "Rebuilding America." That is a program which we believe could do very much to solve this interest rate inflation, as well as address the attendant problems of economic malaise that is the fallout of it.

We think there is a way to put America back into a world leadership role in every sense of the term—right up front, without relying overly on unending sacrifices and austerity policies.

With your permission, Mr. Chairman, I would volunteer to submit relevant portions of that program to the record for the committee's use.

Senator WEICKER. It will be included in the record at this point.

Mr. WINPISINGER. I will get them to you as rapidly as I can.

[Subsequent information was received and follows:]

Attachment A

REBUILDING AMERICA IN THE 80's

A Reindustrialization Program Proposed by

the International Association of Machinists and Aerospace Workers

Rebuilding America's Inner Cities.

This bill meets a fundamental national priority: ensure the peace and domestic tranquility, primarily in the nation's inner cities. The Inner Cities are our own Third and Fourth World tinder boxes. To ignore and continue to shortchange them is to risk rebellion on a massive scale. No one knows just which next turn of the economic screw will launch that rebellion. But it is perilously near. Police action will not quell it. Neither will welfare state tokenism, nor small doses of liberal capitalism. Those have been tried, half-heartedly, albeit, and found wanting.

The beauty of this program is: (1) it provides the kind of massive long term funding necessary (2) without interrupting the budgetary process (3) without creating a federal bureaucracy and federal red tape and guidelines (4) permits the people at the local government and neighborhood levels to design and develop their own programs (5) generates its own payback revenues by (6) utilizing the private money markets.

The program is keyed to the Federal Financing Bank, an off-budget office in the Treasury Department, which has earned $175 million for the U. S. in 5 years and which is fully staffed with only 4 people.

Local and individual initiative, fiscal integrity and responsibility, and social responsibility are the hallmarks of this program.

It represents the last best hope to develop our own underdeveloped economies, and extend the American way of life for millions of economic and socially disfranchised citizens.

It will spur productivity, economic growth and employment, without adding to the national debt, debt servicing cost and inflation.

It is a Marshall Plan package for the nation's cities and the people in those cities.

Rebuilding America Act of 1981

Inner Cities

Title I It is the purpose of this title to rehabilitate and rejuvenate the infrastructure of older communities in large metropolitan areas and to simultaneously develop their underdeveloped local economies.

Any incorporated municipality of 250,000 population or more (1980 Census) may apply for Inner City Development funding if it (1) specifically defines a neighborhood or area within its boundaries as an underdeveloped depressed zone, based on chronically high unemployment and low per capita income as determined by census results. (2) constructs a comprehensive development program which (3) is locally conceived with full planning participation by democratically elected representatives of affected residents, workers and government officials and (4) which, upon completion of the plan, is approved by a simple majority of citizen voters residing in the designated development zone and (5) which thereafter establishes a locally controlled not-for-profit Community Development Corporation to implement and administer the program in the designated development zone.

The Community Development Corporation will apply for funding to the Federal Financing Bank, an existing off-budget agency of the federal government for low-interest long term loans (up to 40 years) and the CDC may sell at competitive rates, Certificates of Participation to individual citizens, private and public pension funds credit unions and neighborhood cooperative banks to raise additional monies, such Certificates to be guaranteed by the federal government in an amount up to $20 billion.

The comprehensive development program will include the following components:

a. bridge, street, alley and public walkway improvement and construction
b. public lighting, utility and water system improvement and construction
c. sewer improvement and solid waste collection and disposal systems
d. public transportation system improvement and modernization
e. local alternative safe energy production facilities, such as Co-generation, low-head hydro, solar systems, and resource recovery (solid waste fuel) systems
f. neighborhood school plant and equipment rehabilitation and modernization
g. medical and dental clinic facilities
h. legal clinic facilities
i. Government Office Center for access to most often used local, state and federal offices, such as employment and unemployment services, Social Security, food stamps and welfare services, postal services and police and fire protection

j. neighborhood drug abuse treatment, drug control and prevention and drug users rehabilitation program

k. neighborhood crime prevention and crime control program

l. Homesteader Housing program, which may be undertaken through a local cooperative association. No resident or family will be forced from their domocilo if they wish to homestead or rent, except voluntarily for a period of home rehabilitation and rennovation

m. senior citizen cooperative housing, health, nutrition and utility payment program

n. child care programs for working parents

o. neighborhood cooperative bank under the auspices of the National Consumer Cooperative Bank Act.

p. community-owned media center with guaranteed public access to cable, UHF and VHF television programming, National Public Radio and for the publishing and printing of locally owned and locally managed newspapers and/or magazines

q. sheltered workshops for employment of the handicapped

r. Business and Industrial Development program, which will include a commitment by the CDC to pay the property liability and property loss insurance premiums, and payroll taxes of businesses and industries that locate in the development zone; in exchange, the businesses and industries agree to strictly adhere to federal fair labor, safety and health and labor relations policy and standards. Employee rights to organize, form trade unions and bargain collectively will be guaranteed as a condition for an employer to do business in the zone. Businesses and industries will also abide by environmental and pollution standards, Equal

Employment Opportunity, sex and age discrimination, and child labor laws.

Firms employing undocumented workers will make that fact known to INS authorities in a good faith effort to legally document such workers and continue their employment. Failure to report undocumented workers will result in loss of insurance and payroll tax subsidies and will be punishable by severe fine and jail sentence upon compliance investigation and due process hearing.

Undocumented workers shall have the right to organize for purposes of collective bargaining and to form and join free trade unions, in compliance with the national labor relations laws.

Firms employing the services of management consultants and/or engaged in other anti-trade union activities will be ineligible for the insurance premium and payroll tax subsidies.

s. local labor force requirement - hiring priority for any phase of the Development Program will be given to workers in the development zone.

Advertising bids for contract construction will specify union labor and contractors will adhere to prevailing area negotiated wage and benefit levels. Corollary Apprenticeship and Youth Job Training programs will be conducted and administered through the aegis of the respective trade unions and/or joint trade union/management programs.

In the event the CDC receives major supply or equipment bids from foreign-based firms, it may accept such bid if the foreign firm agrees to a "local labor content" provision and locates in the development zone to satisfy that requirement. Foreign firms will also abide by and enjoy the benefits of all other business and industry provisions in the development program

t. the CDC will rely upon local or state supported colleges and universities for professional services, such as architects, lawyers, economic, financial and marketing experts, industrial designers, engineers, planners and other specialists.

Each Inner City Development Program will be limited to not more than a $5 billion loan from the Federal Financing Bank. Proceeds of the loan may be distributed over a period not exceeding 10 years.

Each CDC will maintain strict budgetary and cost-limitation standards. Cost-plus contracting will not be permitted.

Congress hereby directs the Treasurer of the United States to earmark annually a portion of the oil windfall profits tax for use by the Federal Financing Bank.

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Rebuilding America's Foreign Trade

The critical problem in international trade today is the absence of any rules of the game, which provide American workers common ground with foreign workers, on which to compete.

The United States has always stood aloof from export promotion and systematic business-labor-government cooperation in pursuit of foreign trade, while other industrialized nations have aggressively developed their foreign trade posture through an overall policy of packaged trade and aid deals and trade promotion, with labor and trade unions playing a key policy making role.

International trade policy in the United States is almost exclusively determined by relatively few private Corporate interests, each individually seeking to maximize their position in world markets. As International Economic expert, Professor Ronald E. Müller of American University, incisively observes, U.S.-based multinational corporations continue to preach the doctrine of free trade and free markets, when the reality is that bargaining between multinational corporations and world governments has displaced classical market forces of supply and demand. The bargaining process between private corporations and world governments often make free trade and free markets a mockery and contradiction of terms.

There are no significant competitive forces in this situation. Instead of being based on classical market forces between companies or corporations exclusively, the deals now involve the heavy intervention of governments, in all but our own country, where private corporations have a free hand to determine U.S. trade policy, without considering the best interests of the nation. They can and do put their corporate interest above the national interest.

At the same time, the U.S. government trade assistance apparatus is a jury-built labyrinth of regulatory gaps and overlap, special favors and exceptions, and is scattered throughout the attics and remote recesses of a dozen departments, offices, independent agencies, and quasi-public entities.

As the U.S. industrial base declines, as our trade balance deficit mounts, as our current account balance shrinks, as our balance of payments deficit remains in the red, cries for reform are at last being heard. Piecemeal though they may be, the proposed reforms being offered at least are recognition that the United States direly needs an aggressive and coherent international trade policy.

Successful international economic reform means taking the system as it is and adapting and adjusting it to the realities. In the U.S., the reality is that international trade is a bargaining process, wrapped and sold in hundreds of commercial contracts, negotiated between private U.S. companies on one side of the table, and foreign governments or government-backed foreign-based multinational entities on the other side.

The reforms in this bill recognize those realities and capitalize on them in pursuit of an aggressive, coherent international trade posture, that will promote domestic and world economic growth rather than protectionism and stagflation.

Without growth there can be no reform; but without reform, there can be no growth.

This bill (1) puts the U.S. government's trade apparatii under one roof (2) recognizes the critical and key role of labor in trade policy formulation and successful implementation (3) provides for a comprehensive inventory of U.S. trade strengths and weaknesses (4) gives special attention to U.S. underdeveloped economies and Third and Fourth World needs (5) treats the dual nature of a U.S. economy, which is divided between a few hundred quasi-soverign Corporate entities dominating international trade at the top, and millions of intermediate and small businesses blocked-off from world trade opportunities below (6) utilizes existing contract bargaining procedures to implement reciprocal fair trade rules in promotion of peaceful, free-flowing international trade.

The resulting benefits of this program will surely outweigh it's costs, many, many times over.

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Rebuilding America Act of 1981

Worker Productive Parity

Fair and Reciprocal Trade

It is the purpose of this title to (a) make efficient and give cohesive direction and purpose to the nation's international trade policy, (b) by providing American workers with the means to achieve productive parity with foreign workers, who have advantages of national economic and social planning to promote growth and full employment in the context of free flowing world economic trade.

In order to achieve the purposes of (a) above, the International Trade Agency is created.

The Agency will have exclusive responsibility within the Executive Branch for trade policy formulation and implementation, enforcement and negotiations.

The agency will assume the international trade functions from the Departments of Commerce, Labor, State and Treasury, the United States Trade Representative, and corollary offices and independent agencies, including the U.S. Customs Service, the United States Export-Import Bank, the United States International Trade Commission, and the Economic Support Fund, Trade and Development Program, Food for Peace Program (P.L. 480), and Overseas Private Investment Corporation of the International Development Cooperation Agency.

The Agency will have a Director, nominated and appointed by the President, with the advice and consent of the Senate and concurrence by a simple majority of the members of the House of Representatives Ways and Means Committee.

The Director will serve at the will and pleasure of the President, be granted Cabinet level status, conferred Ambassadorial rank, with salary and perks commensurate.

The Agency will have the following offices, each headed by a Deputy Director, nominated and appointed by the President with the advice and consent of the Senate:

(a) Transition and Interagency Cooperation
(b) Congressional Liaison
(c) Labor Industrial Sector
(d) Export Promotion and Priorities
(e) Import Review and Policy
(f) Trade Negotiations, Agreements and Enforcement
(g) Multinational Corporation Monitor
(h) Intermediate and Small Business Assistance
(i) Third and Fourth World Aid and Trade
(j) East-West Trade
(k) Tax Policy Review and Recommendations
(l) Appeals and Grievances

Each Deputy Director will report directly to the Director, and be given status, salary and perks commensurate with the Deputy Secretary level.

A. The duties of the Deputy Director for Transition and Interagency Cooperation are apparent on their face, and the office will be abolished upon completion of these duties, when the International Trade Agency is established and functioning.

B. It will be the duty of the Deputy Director for Congressional Liaison to (1) keep the Congress fully informed of the activities, programs, problems and progress of the Agency and its offices (2) keep the Director and Deputy

Directors informed of Congressional actions and sentiments with respect to legislation and policy formulation (3) prepare and present a proposed international trade legislative agenda for the President to present to the Congress and the people each year.

C. The Deputy Director for the Labor Industrial Sector will be a bona fide trade union member, experienced in collective bargaining and trade union administration.

During interim vacancies in the Agency Director's office or during extended absences by the Director, the Deputy Director for the Labor Industrial Sector will serve as Acting Director for the International Trade Agency.

It will be the first duty of the Deputy Director for the Labor Industrial Sector to develop an economic and social clause on which to base international trade policy and programs that will (1) promote domestic full employment and economic growth (2) preserve and strengthen the nation's industrial base (3) improve productive parity and, hence, productivity (4) link and tie U.S. trade and aid to the promotion of economic and social justice for workers abroad, as well as at home, with emphasis on guaranteed democratic human and trade union rights, fair distribution of wealth and income, safeguards against environmental, health and safety hazards, the promotion of international peace and freedom from oppression and exploitation, whatever the source.

The economic and social clause principles will be incorporated into all activities and decisions made by the Agency and its offices, and will be negotiated into all private and public trade agreements in which the U.S. government or private entities are a party.

C-1. The Deputy Director for the Labor Industrial Sector will appoint a 24-member Labor Industrial Sector Board comprised of 24 trade union members, with hands-on production and collective bargaining experience.

The Board will function as an autonomous fact finding and recommending body to the Agency.

It will have subpoena powers for those purposes.

The Deputy Director for the Labor Industrial Sector will chair the Board.

Each Board member will, in turn, chair and be responsible for the activities of one of the following Industrial Sector Committees:

Aerospace

Air Transport

Alumium, Copper and Non-ferrous Mining and Manufacturing

Automotive and Automotive Supply

Building Construction Materials and Equipment

Chemical

Communications and Communications Satellite

Electrical Equipment

Electronics and Microprocessing

Energy and Fuels - Fossil

Energy Sources - Renewable

Exotic Minerals and Metals

Food and Fiber Production and Processing

Heavy and Industrial Construction Equipment

Machine and Manufacturing

Machine Tool and Tool and Die

Marine, Shipbuilding and Water Transport

Medical Equipment, Medicines and Pharmaceuticals

Oceanology

Plastics

Rail Equipment and Rail Transport

Rubber

Steel, Iron and Alloys

Advanced R & D and New Products

The Board, through each of its committees, will canvass and survey the basic and major manufacturing and industrial sectors to determine the condition and status of each and compare those findings with conditions in other industrialized and developing nations.

The Board will make short run and long run forcasts on the strengths and weaknesses of the industrial sectors, including structure of ownership and control, financial condition, market shares, trends and potential, raw material supplies and costs, state of technology and employment and earnings forecasts.

The Board will develop an agenda of national industrial priorities, consistent with the economic and social clause.

In cases of failing companies, or industries threatened with extinction, the Board will have the duty and power to recommend either (a) public ownership including community/worker ownership, or nationalization (b) taxpayer subsidies or their elimination or government-private joint ventures (c) taxpayer loans or loan guarantees (d) acquisition or merger (e) consolidation (f) divestiture (g) bankruptcy (h) liquidation - all consistent with the economic and social plan.

In the case of runaway firms or plants, transfers of capital or technology, or licensing or Co-production agreements, the Board will have the duty and power to recommend either affirmatively or negatively, in consonance with the economic and social clause objectives.

The Board, in cases of economic dislocation, including those that are a result of imports and import policy will prepare local employment, income and economic impact analyses and develop an economic reconstruction plan to (1) protect workers' income and health benefits, (2) provide job security, job training and continuity of employment and (3) to make the impacted local economy viable.

(Trade Adjustment Assistance Act may be incorporated into this plan).

The Board will monitor multinational corporate behavior with respect to human rights, labor relations and trade union rights and the other components of the economic and social clause.

The Board will cooperate with the International Trade Union Secretariats, domestic and foreign central trade union bodies and may assist in forming ad hoc international trade union councils on either company or regional bases, to fulfill its duties and obligations under this Act.

The Board will avail itself of the resources of appropriate domestic and foreign government offices and the various international economic and social agencies.

The Board will submit to the Director and make public biennial reports on its activities, findings and recommendations.

Board Committee Chairs will be considered top level federal management executives and entitled to the same salary and perks.

D. The Deputy Director for Export Promotion and Priorities will be responsible for the functions of the Commerce Department related to export promotion, the U.S. Export-Import Bank, Overseas Private Investment Corporation and those grain, food and fiber export programs now administered by the Department of Agriculture and International Development Cooperation Agency.

The first duty of the Deputy Director for Export Promotion and Priorities will be to conduct a global survey and canvass of corporate, international development and finance agency, and national strategies and tactics, with respect to U.S. economic and trade priorities in terms of (1) marketing objectives (2) price and pricing policies (3) tariffs (4) non-tariff barriers to imports (5) export promotions, incentives and subsidies (6) direct foreign investment (7) foreign domestic investment (8) industrial R & D, technology transfers, licensing and co-production agreements and introduction of new technology (9) new products and services (10) bilateral trade agreements and bilateral development assistance (11) multilateral trade agreements and development programs (12) participation in the World Bank, International Development Banks and the International Monetary Fund (13) floating exchange rates and foreign money markets and (14) tax havens.

The Deputy Director for Export Promotion and Priorities will review all U.S. government programs, regulations, trade agreements and development assistance programs affecting exports of capital, technology, goods and services to identify: (1) bureaucratic overlap (2) regulation gaps or the need for deregulation (3) hidden trade barriers (4) trade incentives and (5) failures or successes and their causes in achieving the objectives of such regulations, agreements and development assistance programs.

The Deputy Director for Export Promotion will report the findings of the global survey and the U.S. government policy review to the International Trade Agency Director and the public, along with recommendations to improve same.

Consistent with the Economic and Social clause developed by the Labor Industrial Sector Board, and in consultation with other relevant offices of the Agency, the Deputy Director for Export Promotion and Priorities will then prepare a schedule of Export Priorities, objectives and the means to achieve them.

The Deputy Director for Export Promotion and Priorities will have licensing authority for all exports of capital, technology, patents, trademarks, plant and equipment and will grant or deny the same, after taking into consideration the Economic and Social Plan and with the concurrence of the Deputy Director for the Labor Industrial Sectors.

In event of a dispute or impasse, the International Trade Agency Director will rule.

E. The Deputy Director for Import Review and Policy will absorb the functions of the U.S. International Trade Commission and the Import Administration of the U.S. Department of Commerce.

The first duty of the Deputy Director for Import Review and Policy will be to canvass and survey each U.S. Government sanctioned program, regulation, trade agreement and development assistance program affecting imports, in order to identify (1) bureaucratic overlap (2) import barriers and import incentives and their rationale (3) their impact on the economy in terms of balance of payments, industrial sector strength, strategic necessity, employment, income, economic growth and foreign relations or other objectives.

Special analysis will be given to Items 806 and 807 of the U.S. Tariff Schedules, the Mexican Industry Border Program, Foreign Trade Zones and the Generalized System of Preferences, with recommendations for review and revision by the Congress.

The Deputy Director for Import Review and Policy will conduct a special review and analysis of the General Agreement on Tariffs and Trade to discover absent signatories and their rationale; violations, compliance and/or noncompliance and the consequences thereof; the increase or decrease in voluntary restraint agreements, or orderly marketing agreements and the resulting effects; the efficiency of the dispute settlement procedures and their effectiveness; and gaps in the treaty that need to be bridged. Upon completion of the GATT Study, the Deputy Director for Import Review and Policy will report his findings to the Director and make recommendations for the improvement and revision of the same.

The Deputy Director for Import Review and Policy, in close consultation with relevant offices of the Agency, will develop a National Import Policy Review System, with specific recommendations for integrating Import policy with the Economic and Social clause.

The Deputy Director for Import Review and Policy shall have the responsibility of administering the Antidumping Act of 1921, as amended, the Countervailing Duties provisions of the Tariff Act of 1930, as amended, and Sec. 201 of the Trade Act of 1974.

For the purpose of determining whether unfair trade practices or increased imports are a substantial cause of serious injury, or the threat thereof, to a domestic industry producing an article like or directly competitive with the imported article, the Deputy Director for Import Review and Policy shall appoint a panel of seven experts, including at least one trade union representative of the workers in the domestic industry concerned, and shall provide suitable staff assistance. The panel shall report its findings within 60 calendar days to the Director of the International Trade Agency (or, in exceptionally complicated cases, within 90 calendar days). The Director shall refer the findings to the Deputy Directors for the Labor Industrial Sector, Import Review and Policy, Intermediate and Small Business Assistance, Third and Fourth World Aid and Trade and the Multinational Corporation Monitor for their recommendations as to further action. Within 30 calendar days they shall report their proposals to the Director who shall rule on the matter.

F. The Deputy Director for Trade Negotiations, Agreements and Enforcement will be responsible for the Conduct of same.

(S)he will be second only to the Director of the International Trade Agency as the nation's chief trade negotiator, and will be accorded Ambassadorial rank.

Along with the Director, the Deputy Director or their designees will head each U.S. trade negotiation team, whether those negotiations concern bilateral, or multilateral agreements, are conducted with private or public entities, are exploratory or oversight in nature.

Along with the Director, the Deputy Director will select the members of each negotiating team.. Members may be chosen from the private sector or the public sector, but each negotiating team will have two trade union members recommended by the Deputy Director for the Labor Industrial Sectors.

The Deputy Director for Trade Negotiations, Agreements and Enforcement will be held accountable to the objectives and principles of the Economic and Social clause.

Persistent and/or serious breach of the clause may lead to recall, replacement, or both.

The Deputy Director will be responsible for policing and enforcement of all U.S. trade agreements and the top investigative personnel of the U.S. Customs Service will be based in and function under the direction of this office.

G. It will be the duty of the Multinational Corporation Monitor to act as the Agnecy's Ambassador-At-Large to the transnational Corporate Community, both U.S. and foreign-based, which represents a new quasi-sovereignty in the world economy and world affairs.

The Multinational Corporation Monitor's primary duties will be to (a) keep the Agency and the public informed on the activities, behavior, policies and practices of multinational corporations in the world economic and trade arena (b) make aware and press upon multinational corporations their responsibilities toward fulfilling the objectives of this Act and the Economic and Social clause, at home and abroad.

The Multinational Corporation Monitor will note the investment and marketing strategies, pricing policies and market shares of major multinational corporations in international trade.

The Monitor will analyze the control, structure, ownership, holdings and subsidaries of multinational corporations.

The Monitor will analyze intracorporate transfer pricing practices, with the aim of formulating accounting principles based on arms-length pricing.

The Monitor will propose suitable regulations and legislation to eliminate tax evasion and cross-subsidization of subsidiaries.

The Multinational Corporation Monitor will note the relationships of multinational corporations to cartels and other international business consortia.

The Monitor will note multinational corporation relationships with foreign governments, international agencies and foreign multinational entities.

In this conjunction, it will examine the activities, objectives and principles of the International Business Roundtable.

The Monitor will make recommendations to correct multinational corporate abuses of power and will recommend ways for multinational corporations, both U.S. and foreign-based operating in the U.S., to comply with the principles and goals of the goals of the Economic and Social clause.

The Monitor will submit an annual report to the Director, which will be made public.

Tha Annual Report will include the findings and recommendations of the Labor Industrial Sector's office with respect to human and trade union rights and labor relations.

The Multinational Corporation Monitor will have subpoena powers for the purposes of fulfilling these duties.

H. The Deputy Director for Intermediate and Small Business Assistance will act as the Agency's chief liaison officer with the domestic business community.

The Deputy Director will work closely with the Export-Promotion and Policy office and Import Review and Policy office in order to assist small and medium-sized businesses in maximizing their share of world trade opportunities, consistent with the Economic and Social clause.

The Deputy Director for Intermediate and Small Business will give special attention to the Research and Development, Market survey and information, credit, financial and foreign currency; patent, and trademark, and licensing and permit needs of such businesses.

Priority consideration will be given to those firms and enterprises located in the Inner City Development Zones described under Title I of this Act.

Additional priority will be given to those firms marketing new and socially useful technology, products and services.

The Deputy Director for Intermediate and Small Business, will cooperate and coordinate activities with the existing Small Business Administration, keeping intact the objectives and principles of the Economic and Social clause.

I. It will be the primary duty of the Deputy Director for Third and Fourth World (including the People's Republic of China) Aid and Trade to design and implement an economic development strategy that recognizes the existence of large and declining underdeveloped local or regional areas in the U.S. (1,092 Labor Surplus areas) and the basic human and economic needs of less developed nations.

Such a strategy will seek to develop the U.S. underdeveloped areas and declining industries, as well as foreign less developed countries by (a) making reciprocal trade, investment and aid agreements that will result in a net contribution to each country's balance of trade or current account and (b) reciprocally implement the principles and goals of the Economic and Social clause.

The strategy will focus on agricultural development and food supply potential; development, or lack thereof, of (1) roads, rail, and water transportation and facilities, (2) community water sources and systems, (3) sewage and sanitation systems, (4) energy and electric systems, (5) communications systems, (6) capital goods requirements.

The Deputy Director, after determining the potential for development of a country's infrastructure, will prepare a prospective reciprocal trade, aid and investment package to be negotiated between the U.S. and the country. The development prospectus may be regionalized. It will honor the Economic and Social clause.

If a country agrees to negotiate a development program, the matter will be turned over to the Deputy Director for Negotiations, Agreements and Enforcement for conclusion.

All U.S. private negotiations and contracts with the People's Republic of China and Third and Fourth World governments and enterprises will be made through and in consultation with the Office of the Deputy Director for Third and Fourth World Aid and Trade.

The Deputy Director for Third and Fourth World Aid and Trade will canvass and survey each of the U.S. underdeveloped areas, noting their assets and liabilities, in terms of human and natural resources, marketing, production and transportation characteristics.

The Deputy Director will actively recruit foreign direct investment in U.S. underdeveloped areas and prepare investment prospectuses for this purpose. Each prospectus will honor the Economic and Social clause.

All private and state and local government negotiations with foreign governments and enterprises will be conducted with the approval of the

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Deputy Director for Third and Fourth World Aid and Trade and agreements or contracts resulting therefrom will conform to the Economic and Social clause.

J. The Deputy Director for East-West Trade will be responsible for developing and regulating exports to non-market economy countries with the exception of the People's Republic of China.

The Deputy Director will be the point of first contact for all U.S. private and governmental interests in East-West Trade relations.

The Deputy Director will be the conduit through which Soviet and Eastern trade initiatives will flow.

The Deputy Director will analyze all trade and aid proposals in light of the objectives and purposes of this Act.

The Deputy Director will review and make recommendations with respect to most-favored nation status of non-market economy countries.

The Deputy Director will promote the Economic and Social clause in East-West trade relations.

The Deputy Director will annually canvass and survey sector-by-sector the condition and state of the non-market economies and report same to the Director.

The canvass and survey will note and analyze trade and aid strategies, policies, and programs with respect to other countries and multinational corporations.

The report will be made available to the public in a timely manner.

The Deputy Director will assess the state of technology, industrial R & D, and the introduction of new technology in the Soviet and Eastern economies and report same to the Director.

The Deputy Director will enforce the Export Administration Act with respect to non-market economy countries.

The Deputy Director will be an advisor to all trade and aid negotiations with the non-market economy countries.

K. The Deputy Director for Tax Policy Review and Recommendations will analyze and assess the impact of current tax laws, regulations, exemptions and special tax treatments on U.S. trade, and current account balances.

A sector-by-sector approach, with firm and product specifics, will be taken. Focus will be on Deferred Taxes on Foreign Income, Tax havens, intracorporate transfer pricing and transactions to avoid taxation, and identification of tax barriers and tax incentives to exports and imports.

The Deputy Director for Tax Policy Review and Recommendations will survey foreign tax policies and practices with respect to their international trade posture.

Focus will be on tax lures and incentives that attract foreign investment, particularly U.S. investment. Special attention will be paid to foreign trade-related investment performance requirements (local content requirements and export quotas).

Upon completion of the domestic and foreign tax impact studies, the Deputy Director will make recommendations for U.S. tax revisions that will enhance the objectives of this Act, and other proposals for dealing with trade-distorting investment performance requirements.

The Deputy Director will prepare a proposal for international Conferences on Uniform Tax Policies and Fair Trade.

One Conference would focus on the industrialized nations.

A second conference would focus on the Third and Fourth Worlds.

The purpose of the Conferences would be to (a) identify and ultimately eliminate unfair tax advantages and incentives in international trade (b) promote the concept of progressive taxation based on ability to pay among all nations.

L. The Deputy Director for Appeals and Grievances will chair a 5-member Board of Appeals and Grievances to hear complaints, filed by U.S. private interests and individuals, U.S.-based multinational corporations, U.S. trade unions, and foreign governments and foreign-based multinational corporations, against agency rulings and decisions in an effort to resolve conflicts and disputes before they are taken to the Courts, presented for international arbitration and settlement, or become irreconcilable.

The members of the Board of Appeals and Grievances will be appointed by the Director of the Agency. At least two members of the Board will be trade union members.

The Board will hear and rule on Trade Adjustment Assistance appeals.

An Economic and Social clause would contain the following reciprocal agreements:

1. A commitment to economic planning for Full Employment and real economic growth.
2. A commitment to develop domestic markets.
3. A commitment to real per capita income gains for workers.
4. A commitment to redistribution of and social control over, concentrated land and wealth.
5. A commitment to annually devote a portion of the nation's wealth and income to a civilian Economic Development fund to be used indigenously for job creation and worker training.
6. A commitment to eradicate starvation, malnutrition, hunger, disease, illiteracy, ethnic, racial, religious and sex discrimination, and child forced prison and slave labor.
7. A commitment to water and air pollution control and environmental protection standards.
8. A commitment to develop safe, renewable, non-nuclear low cost energy systems and a commitment to nuclear nonproliferation.
9. A commitment to access to media by the public, trade unions and democratic opposition political parties.
10. The absolute right of freedom of association for workers; the guaranteed right of workers to organize and form free and independent trade unions for purposes of collective bargaining with employers – private, government or any combination thereof – over the terms of their wages and compensation, hours, safety

and health and other working conditions; the inviolable right to use the strike as an economic weapon in the collective bargaining process.

11. The right of workers and their trade union representatives to help formulate, promulgate, implement and police the economic and social plan in their respective places of work, firms, industries and at all government levels.
12. The right of workers and their trade union representatives to have access to enterprise and government data and information relevant to costs, pricing policies, including the right of workers and trade unions to participate in planning and decisions for expansions, transfers, nationalizations, redundancies, and the introduction and deployment of new and labor saving technology.
13. The right of workers and trade unions to participate in the political processes, form political parties and/or make political alliances and coalitions and the right of trade unionists to seek public office.
14. Multinational Enterprises will be bound by the ILO and United Nations Codes of Conduct. Breaches thereof will be referred to the World Court for adjudication and remedy.
15. Where national laws are non-existent or weak, International Labor Organization minimum standards on wages, hours, safety and health and other working conditions and freedom of association will prevail and be strictly enforced by the parties to the agreement.

16. Where an international aid, trade, or investment agreement involves military goods and services, a 10% surtax will be levied on the vendor's after-tax profits and paid into the United Nations Peace Keeping Mission.

Current Session Foreign Trade Issues:

1. Trade Adjustment Assistance Act coverage will be expanded to cover employees impacted by imports at the secondary and tertiary levels.

   Employees of independent auto dealers will be covered. Health insurance coverage will be provided to TAA recipients. The Job Training provisions of the TAA will be doubled in size and scope and full relocation expenses will be paid for job placement in other communities.

2. Oversight hearings will be held on the Multilateral Trade Agreements with emphasis on compliance or non-compliance by trading partners.

3. Hearings will be held on the existence of non-tariff barriers to trade - what forms they take, what impact they have on U.S. exports and employment.

4. The Generalized System of Preferences should be reformed to include sectoral graduation of newly industrialized countries, and to deny benefits to countries that cause serious prejudice to U.S. trade and employment.

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Summary Statement

Rebuilding America

Domestic Economic and Industrial Policy

Abandoned plants and mills, rusted rail sidetrackage, technologically outdated steel mills, rubber plants, and textile and apparel factories, ghostly electronic plants, and crumbling industrial cities are stark reminders of America's declining industrial base. Chrysler and the auto industry are just the tip of the iceberg.

Meantime, inflation and persistent high unemployment weigh heavily on the backs of working people, the jobless and the poor. Plants shut-down, move or runaway, stranding workers and entire communities in their wake. Defense contracts expire, are shifted about, contracted-out or sent overseas for off-shore procurement. Increased military spending goes to highly capital intensive firms and doesn't create enough jobs to take up the slack in the declining civilian sector.

Corporate giants, loudly proclaiming to be champions of "free" enterprise, are lined up in the Halls of Congress and at the White House door, pleading for federal assistance and bail-outs in one form of tax and regulatory concession after another. Cut taxes, deregulate, undermine wages, hours and working conditions, bust unions and get the hell out of the way is their cry.

The fashionable name for their program, which is a throwback to the 1920's just before The Crash, is "reindustrialization." It is a clever flag-word designed to arouse people and workers to a sense of urgency, with a touch of patriotism thrown-in.

There are several variations on the reindustrialization theme, but all schemes have several basic things in common. All assume that corporations do not have enough capital to invest in new plant and equipment - despite nearly three years of record smashing profits in 1977, 1978 and 1979, and in spite of investments overseas estimated to run at about $30 billion per year. All schemes assume neither government nor trade unions have any business meddling with business decisions. All schemes assume corporate management is the sole and best judge of how to run the economy. All schemes assume a competitive free market with supply and demand determining prices and resource allocation - when in fact a few giant firms control most industrial production and markets. Altogether, about 800 giant firms, many wealthier than most nations, control 70 percent of the business transactions in this country, while some 11 million firms dogfight for the remaining 30 percent of business.

The trouble with these reindustrialization schemes is it excuses corporate management from any kind of community-wide economic and social responsibility. It excuses corporate management from getting us into the mess we're in - and the deeper disaster looming on the horizon. After all, it wasn't the government or the environmentalists that gave us Love Canal, Three Mile Island, and PCB. It wasn't the government, but the major oil companies that hooked us on OPEC. It wasn't the government or the UAW, but the auto manufacturers who refused to build small and fuel-efficient cars in this country. And it is the steel companies who have chosen to diversify into chemicals and Dixie Cups, rather than reinvest profits in modern steelmaking plants and equipment.

It is corporate management buying into foreign firms and shipping production and technology overseas. It is corporate management choosing to exploit Third and Fourth World countries, while creating our own underdeveloped economy here at home. It is private U.S. banks that have over-extended themselves with loans to dictatorial and right wing governments that cannot be paid back, not the Foreign Aid program.

Opportunistic and shortsighted corporate planners have led us to the brink of industrial breakdown. There is no reason to suppose that given a totally free hand in planning our economy, they will behave any better.

It is the puspose of this title of the bill to achieve domestic full employment and economic growth by (1) making corporations responsible to the communities where they do business and to the nation as a whole (2) through coordinated domestic economic planning to meet priority industrial needs in both the civilian and military sectors of the economy (3) by protecting workers and communities from arbitrary and sudden corporate decisions to shutdown, move, and introduce new technology (4) and by providing a key role for trade unions to play in determining and establishing a national industrial policy.

The main features of this bill are:

(1) Corporations doing business in interstate commerce would be federally chartered and would be required to meet certain economic and social standards written into that charter, such as the guaranteed right of trade unions to organize and bargain collectively, guaranteed human rights for workers on the job, job safety and health protections, environmental safeguards, and support of a federal investment reserve fund.

(2) Economic and production priorities would be synchronized with foreign trade, regional, state, urban and rural priorities and needs, and determined through a national investment and production agency.

(3) Corporations would be required to show cause why they must close, shutdown, move or transfer operations, and if a corporation failed to show cause, it would be permanently enjoined from doing so.

(4) Economic development programs would be tailored to meet specific instances of economic dislocation.

(5) New technology would be monitored and regulated to protect workers' privacy, ease job loss and facilitate job transition, and research and development programs would search for new products, new markets and, thus create new job opportunities.

(6) A National Employment Opportunity Service utilizing the latest and most sophisticated speed-of-light technology would be implemented with the capability to move into local plant and job sites, in order to match-up idle skills with job opportunities anywhere on the continent.

(7) A National Industrial Development Bank would fund and make loans to job creative industrial development programs on an industrial production priority basis. Initial funding for the bank would come from deregulated gas and oil windfall profits taxes, a surtax on profits of defense contractors.

(8) In cases of aggravated inflation in monopolistic markets and the basic necessities of life, targeted economic controls programs would be developed and utilized.

Under this title, state labor laws would be made uniform to conform to the highest standards, prevent corporations from exploiting differences among the states, and the Right-to-Work (for less) law would be automatically repealed.

The essence of this bill is that Corporate America would be required to sign an economic and social contract with its workers and with the communities in which it operates.

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Rebuilding America

Domestic Economic and Industrial Policy

It is the purpose of this title to promote full employment and economic growth by: (1) legally defining large corporations as entities with economic and social responsibilities to the communities in which they operate and to the nation as a whole; (2) providing for coordinated domestic economic planning; (3) protecting workers and communities against sudden plant closures, transfers and mass lay-offs.

A. Private corporations doing business in interstate commerce are deemed to be operating for the convenience and needs of the community, in the public interest for the benefit of the public and in expectation of benefit to the public, and will be federally chartered.

The Secretary of Commerce will issue federal corporate charters and establish the fees and procedures for same.

Each federal charter will include an economic and social clause that will commit the corporation to (1) guaranteed human rights in its employment policies and practices and its corporate conduct in the community (2) guarantee its employees the right to organize and bargain collectively for wages, hours, working conditions, etc. (3) protect workers and communities from environmental, health and safety hazards (4) provide one year's advance notice to the Secretary, the community and to its workers in event it finds it necessary to shutdown, close, move, transfer or otherwise curb or curtail all or part of its operations, such necessity to be proven at a public show cause hearing, if challenged by the workers and/or their bargaining agent, and/or by community petition (5) annually pay an amount equal to 1% of net sales into a federal investment reserve fund.

E. The Domestic Investment and Production Agency is created.

The Agency will have exclusive responsibility within the Executive Branch for domestic economic policy formulation and implementation. It will have the primary duty to develop an industrial policy that will achieve and sustain full employment, mitigate economic dislocation, allocate resources and facilitate the transfer of resources to designated areas of priority need and critical and emergency needs.

The Agency will have a Director, nominated and appointed by the President with the advice and consent of the Senate.

The Director will serve at the will and pleasure of the President, be granted Cabinet level status, with salary and perks commensurate.

The Agency will have the following offices, each headed by a Deputy Director, nominated and appointed by the President, with the advice and consent of the Senate:

Congressional Liaison and Interagency Cooperation
National Priorities
Foreign Trade Agency Coordinator
State, Regional and Urban Development
Rural Development and Land Use
Research, Development, New Products and Marketing
Capital Formation and Mobility

Each Deputy Director will report directly to the Director and be given status, salary and perks commensurate with the Deputy Secretary level.

1. The duties of the Congressional Liaison and Interagency Cooperation Deputy Director are apparent on their face and (s)he will (a) keep the Congress fully informed of the activities, programs,

problems, and progress of the Agency and its offices (b) keep the Director and Deputy Directors informed of Congressional actions and sentiments with respect to legislation and policy formulation (c) maintain liaison with all other departments and agencies of the federal executive (d) develop and prepare each year a legislative agenda for the President to present to Congress.

2. The Deputy Director for National Priorities will have the following duties: (a) through social cost-benefit analysis, review and evaluate all federal assistance, regulatory and tax programs affecting economic development, in order to identify overlaps and/or gaps, excessive bureaucratic costs, and tax barriers or bonanzas (b) canvass and prioritize economic and social needs in the civilian sector of the economy (c) independently review, assess, prioritize and make recommendations to reconcile the economic demands of the military sector of the economy, with the needs of the civilian sector (d) develop an economic adjustment and development plan that will (1) fulfill unmet civilian economic and social needs, (2) meet realistic requirements of the military (3) in the event of economic dislocacation, whenever and for whatever reason, protect workers income, health care and housing; provide job training and continuity of employment; sustain vital community services that may be impaired and develop an economic reconstruction plan that will make impacted local economies viable and whole.

The National Priorities Deputy Director will have discretionary use of the federal investment reserve fund (A.5) for the purpose of d(3) above.

The National Priorities Deputy Director will, upon notice from the Secretary of Commerce that a federally chartered corporation's advance notification of intent to close has been challenged, by either the workers or community; appoint a five-member public commission to hold public hearings in the local community, where it will be incumbent upon the corporation to show cause why it cannot continue to operate profitably for the convenience and needs of the community.

The Commission will have subpoena powers to produce witnesses, corporate data and information.

Corporate data and information will be shared with petitioners.

Petitioners may call for expert witnesses and testimony.

If the Commission finds the corporation failed to show cause, a permanent injunction will be issued to prevent the corporate shutdown, move or transfer.

Quick-sale successors, whether intrastate or interstate or foreign, will be bound by the economic and social clause of the original federal charter.

The corporation may appeal the Commission's finding to the federal courts, and petitioners may also appeal.

If the corporation violates a permanent injunction, the National Priorities Deputy Director will recommend to the Director federal seizure and operation of the facility or business.

In cases of failing enterprises or enterprises faced with extinction, the Deputy Director will have the duty and power to recommend to the Director a plan for either (a) public ownership including, community/worker ownership, or nationalization (b) taxpayer subsidies, or their elimination, or government-private joint ventures (c) taxpayer loans or loan guarantees (d) acquisition or merger (e) consolidation (f) divestiture (g) bankruptcy (h) liquidation - all consistent with the economic and social clause.

The public hearing Commissioners will be selected from the American Arbiters Association and none may have a direct or indirect pecuniary or vested interest in the corporation.

They will be paid per diem expenses while hearing the case, plus a reasonable fee while coming to their decision, which will be written, with majority and minority opinions.

All records and transcripts of the proceedings and decision will be made public and become the property of the federal government kept in trust for the people.

Costs of the show cause hearings will be borne by the Agency.

The Deputy Director for National Priorities will recommend ways to achieve uniform federal labor laws and standards consistent with the highest denominator of the economic and social plan recommended by the Labor Industrial Sector Board of the International Trade Agency, as prescribed in the Inner Cities' development zone and as required in the federal corporate chartering procedure in A above.

Whenever inflationary prices persist for six months or more in industries characterized by monopoly or oligopoly, or by other non-competitive forces, or in industries supplying the basic necessities of life, i.e., energy and utilities, food, housing, health care and transportation, the Deputy Director for National Priorities will investigate and analyze the causes of those inflationary prices, and will develop a targeted economic controls program for such industry or industries, and recommend to the Director that the President invoke economic control powers granted by the Congress, or in the absence of Congressional sanction, recommend the President request such authority, and upon Congressional assent and Presidential directive, the Deputy will implement the program.

The Deputy will have subpoena powers for the purposes of conducting the investigation.

Any cost and price monitoring staff necessary to the investigation and analysis and/or necessary to carry-out the controls program, will include at least two trade union members recommended by the Deputy Director of the Labor Industrial Sector Board of the International Trade Agency.

To the maximum extent possible, all other staff for the Economic controls program will be recruited and borrowed from among career civil service employees already in the federal service.

Failure to cooperate in the cost and price analysis and investigation, or failure to comply with controls may lead to federal seizure of corporate assets, management and operation by the Agency, or heavy fine levied on offending corporate directors and executives , or all of the above.

3. The Foreign Trade Agency Coordinator will work closely and in consultation with the Labor Industrial Sector Board of the International Trade Agency.

The Foreign Trade Agency Coordinator will have access to and convey all studies, data and information produced by that Board, to the Domestic Investment and Production Agency, which will utilize the Board as its primary industrial sector research and fact-finding arm.

The Foreign Trade Agency Coordinator will work in consultation and harmony with all other offices of the International Trade Agency as circumstances may require and dictate.

4. The Deputy Director for State, Regional and Urban Development, will have the following duties: (a) establish and maintain liaison with all state, regional and urban industrial development and planning agencies (b) canvass and survey state, regional and urban industrial development plans, comparing incentives and differentials in taxes, wages, land and building costs, labor laws, safety and health and environmental protection laws and regulations (c) canvass and survey sector-by-sector the condition and status of state, regional and urban economies, noting strengths and weaknesses of the industrial base and forecasts for growth or decline (d) prioritize and synchronize state, regional and urban development goals (e) design industrial development programs that will match needs and resources, facilitate the mobility of resources to underdeveloped areas, and which will eliminate artificial economic and social differentials that are used inefficiently and unfairly as industrial development lures and which have socially undesirable consequences.

Each program will be consistent with the economic and social clause in A above.

The Deputy Director for State, Regional and Urban Development will work closely with the Foreign Trade Coordinator in matching resources and needs for industrial development.

5. The Deputy Director for Rural Development and Land Use will have the primary responsibility to develop a long range domestic food and fiber policy.

Duties will include: (a) canvass and survey the economic and social conditions of the rural population on the farms, in the communities, among the Native American nations and migrant labor (b) inventory rural land use and values (c) survey farm production land ownership and control, with income, size and value classifications, and historical trends and projections (d) assess and forecast food and fiber producers' resource needs, on a commodity-by-commodity basis, and compare with domestic needs for food and fiber and export potential (e) prepare and prioritize a rural community needs agenda and develop a business and industrial program, consistent with the economic and social principles in A above, with emphasis on community physical infrastructures (f) prepare and prioritize a farm-to-market production program that will meet domestic food and fiber needs forecasts and synchronize domestic policy with a realistic food and fiber export policy. Such a program may recommend restructuring of the production and distribution system in terms of efficient resource allocation, ownership and control (g) investigate, study and recommend ways to alleviate labor surplus and labor abuses in rural areas.

The Deputy Director for Land Use and Rural Development will coordinate and work in cooperation with the Chair of the Food and Fiber Production and Processing Committee of the Labor Industrial Sector Board of the International Trade Agency.

6. The Deputy Director for New Technology, Research and Development, and New Products will have the primary duty to investigate, study and recommend programs to: (a) monitor the advent and introduction of labor-saving new technology (b) move displaced labor resources upstream in the manufacture, deployment, operation and maintenance of the new technology, before it comes on line (c) train and retrain workers displaced by new technology for employment in areas and occupations where skills and workers are in short supply. In this connection, the

Deputy Director will utilize the new technology in the design of a national employment opportunity service, that will have the capability to move into a local plant and job site and match up redundant job skills with job opportunities throughout the country (d) share productivity and cost-savings with workers impacted by the deployment of new labor-saving technology (e) develop a code of conduct to protect workers' privacy in the workplace and to prevent employers from using the new technology unscrupulously (f) prevent a corporation from gaining monopoly or monopsony market power through new technology (g) seek and find new ways to absorb new technology into job creating and socially-useful production through new markets and new products (h) prepare and prioritize a list of research and development projects that would fulfill or help fulfill unmet and critical national needs, such as energy conversion to safe, renewable energy sources and systems; mass transit; rail revitalization and rehabilitation; inner city infrastructure rehab; seaport and harbor facilities; water transportation; and fuel efficient vehicles.

7. The Deputy Director for Capital Formation and Mobility will have the primary duty to establish and organize a National Industrial Development Bank. (S)he will be the Director of the Bank.

Initial funds for the Bank will come from: (a)a portion of the windfall profits tax realized through crude-oil deregulation (b)a portion of a windfall profits tax to be levied on deregulated national gas (c) a graduated progressive surtax on defense contractor and foreign military sales profits as long as profit controls are in suspension, or until the Vinson-Trammel Act is reinstated, (d) the Bank Director may establish regional, state and local banks (e) may establish industrial sector banks (f) the Bank may issue federally guaranteed bonds to raise capital (g) the Bank may sell federally guaranteed certificates of deposit, to cooperative banks and institutions, to private and public pension funds, to individuals in small and large denominations (h) the Bank may receive and keep on deposit at competitive interest bearing rates, surplus funds of state and local governments, their agencies and subdivisions (i) the Bank will lend money on approved payback schedules to private entrepreneurs, small and medium private businesses and/or corsortia thereof, federal enterprises, government-private joint ventures, consumer and producer cooperatives, community and/or worker-owned enterprises, local, state or regional industrial development agencies and projects, Native American nations, and foreign-based firms investing in the domestic economy (j) each borrower will agree to abide by an economic and social plan, to be negotiated at the time of loan, and which will at a minimum guarantee (1) job creation and/or additional employment (2) compliance with federal fair labor standards (3) human rights in employment policies and practices (4) the right of workers to organize and bargain collectively (5) job safety and health protections (6) community environmental protections (7) safeguards against mass lay-offs due to new technology, shutdowns, moves, or transfers of production (k) Bank loans will be made on the basis of meeting the priorities determined by the Labor Industrial Sector Board and Export Promotion Office of the International Trade Agency, the National Priorities Office, Land Use and Rural Development Office, and State, Regional and Urban Development Office.

The exclusive power of the states to issue corporate charters to firms and business entities operating in interstate commerce is rescinded upon adoption of this Act, except that a state may require its own charter in addition to the federal charter, if the standards and requirements contained in the state charter, are equal to or exceed those contained in the economic and social clause of the federal charter.

Upon adoption of this Act, Section 14(b) of the National Labor Relations Act, as amended, is repealed.

Mr. WINPISINGER. I will stop right there. If there are any questions that I can answer, I would be delighted to do so.

Senator WEICKER. Yesterday I expressed my concern, and I have similarly expressed it in months past, that under the laissez-faire attitudes of this administration, vis-a-vis corporate mergers, because of the high interest rate situation and because of the lack of capital to small businesses, one of two things was happening. Either the small businesses were going belly up, or they are being forced into merging with large corporations who, as you indicate, and I think correctly so, have capital available to them and can afford interest rates at any level. Even though they do not like them, they can at least handle them.

I picked up my newspaper today and saw that this merger trend is continuing with Grumman being bought up by LTV. This is only the latest, as you know, in a rash of super mergers that are going on.

Mr. WINPISINGER. A lot of which intensify the problem.

Senator WEICKER. It seems to me that for whatever immediate benefits might occur this year, or say next year, it is really going to compound the problem ahead in the sense of less competition and fewer companies. I wonder if you would like to comment on that at this time?

Mr. WINPISINGER. I totally agree with your assessment. It is something that we see on a daily basis.

We see not only the continuation and the intensification of this tremendous economic power buildup where the power flows into fewer and fewer hands by virtue of these mergers and absorptions but there is an attendant destruction of job opportunities.

The more economic concentration of that kind we get the less resourceful becomes American business and the less necessity there is to be efficient or to be adventuresome in terms of technological outreach.

We follow the patterns that are designed to take care of the institution of capital and business and corporate life rather than the full spur of competition that we once felt during those periods when we were advancing this Nation across frontier after frontier in the industrial process.

I think we can look into that and beyond it, and we will discover that much of the criticism that American life heaps on different segments of the population today might have its birth in this phenomena.

We hear much about the American worker being lazy. He does not work hard enough; productivity is down and so forth, ad infinitum. I cannot find any empirical evidence that will back up those contentions. They become the popular myth, much as the mandate business about the current administration. The myth often is peddled into reality by repetitively saying it—the Goebels technique, as it were.

The fact is that blue-collar productivity in the country has gone up 7.5 percent in the period 1977–80. We only hired 650,000 new blue-collar workers. We hired 5.5 million white-collar workers whose productivity went down and subtracted from the total, so we had very slow growth.

That is a product of corporate paper pushing that comes in vogue when you get these kinds of concentrations of economic power.

We hear much about quality products and blame American workers for lack of quality and point to other nations which allegedly build quality products.

I am here to say that I know that those nations are not employing the same kinds of sophisticated machinery as we are in many cases, although they treat what they have with a lot more respect, because tax laws are such that you do not abuse the machinery in order to take advantage of tax laws, as we do here.

I might say that in terms of quality, those nations engineer the quality in at the threshold, long before the worker ever is exposed to doing anything mechanically with the product. It is a crusade in some of those countries.

All of those crusades which are going on abroad among our fiercest competitors in the world trade markets are phenomenal, because they make sure that there is some realistic relationship between government on the one hand as a representative of the people and the public interest, and industry on the other to advance policies that are not self-defeating.

That does not mean that they do not keep creating ever-larger conglomerates, and so on, as we seem to be bent on doing here. It simply eliminates most of the incentives there are to be efficient and competitive when you build these kinds of giants.

Senator WEICKER. I have always felt that one of the hallmarks of the success our political system has had, as compared to the other free nations of the world, is that in this Nation a large majority of its citizens actually own a piece of the action.

More often than not I would say that among the workers you represent—the middle economic stream of this country—that means owning a home.

We have gotten to a point now under the economic policies of the past several years where only 3 percent of this Nation can afford to buy a home.

In your contact with the people you represent what are their feelings on these matters, as to what they can afford now—a home or a car or any of the large ticket items.

We talk about small business; now let us talk about the small individual. They are pretty well frozen out of these markets right now.

Mr. **Winpisinger**. The Wall Street Journal this morning disclosed that home mortgage rates are 17 and 18 percent and are climbing.

That puts almost everyone we represent out of the picture—anyone who is not already in it.

Those who are in the twilight of their working careers—my generation so-called—who may have been able to stake themselves economically 25 years ago in the home market are surviving because they are insulated from the ravages of what is going on now. All of their children are the victims of it.

I happen to be the father of five who are all in that bracket. None of those five—even at much more modest interest rates than we are tolerating right now—could have become a homeowner in the greater Washington, D.C., area without some help from somebody.

It is just impossible with the cost of living and with these unconscionable monthly payments which are generated by these kinds of interest rates for anybody out here working, as my one son does, at the Hertz Truck Rental. He cannot make enough money under the union contract, let alone all of those unorganized workers who are not exposed to those kinds of earnings, to be in the home market in this area.

I think that is typical of the entire country to a greater or lesser degree—there are peaks and valleys.

Clearly we have disenfranchised the majority of working people in this country in terms of home ownership in the below $30-thousand bracket, or thereabouts. That possess some awesome consequences, I think, down the line.

These are young people who grew up in households, by and large, where home ownership was taken for granted as the American way, and as one of the benefits of American life, and one of the things you could do if you went out and worked. One of the elements of success was interpreted as home ownership and a reward for hard work.

When you remove that reward, you set in motion a psychological process, and you begin to marry them. You marry them all the way down to the back end of the spectrum, the left and the right, as you have pointed out.

When you do that, you have a potentially very dangerous situation out on the streets of main street America.

I say it, and people scoff at it. I do not say it because I am some kind of revolutionary or anything like that. However, I think it is possible when you take the army of unemployed already out there, and the army of the disadvantaged and the dispossessed when the fruits of the administration's program begin to settle in along about next year—you marry those two and you marry to them all of the frustrated youth of the country who want to start families and want to own a home and are precluded by this unconscionable policy—then you have an army out there that can become very ugly and mean and nasty and do something about it.

I would not want to see things come to that in America. I think just a little bit of compassion on the part of Government can do a lot to head that off and give young Americans the same opportunities their elders had to share in the advancement of our country and share fairly equally—equally, at least, in terms of their own income structures.

Senator **WEICKER**. I agree.

Senator Hayakawa, do you have questions?

Senator **HAYAKAWA**. No, Mr. Chairman.

Senator **WEICKER**. Senator Dixon?

Senator **DIXON**. I would just like to apologize to the witness, Mr. Chairman, for being late. I had the duty on the floor this morning.

Mr. **WINPISINGER**. I am going to hurry off then, because I have some problems as well. I understand that perfectly.

Senator **WEICKER**. One last question then.

Some believe that the high interest rates which are presently being established in the money markets translate into a vote of no confidence in the administration's economic game plan. Would you comment on that?

Mr. **WINPISINGER**. I cast that vote before the administration was sworn in, Senator. [Laughter.]

I have seen nothing that changes any of my thinking. I have seen nothing in terms of the tangible outpourings of the program to change my vote based on a philosophical understanding of it.

As a matter of fact, if anything, they have hardened, by the meanness that is inherent in some of these things, my attitude quite substantially in terms of casting that vote.

It would take something enormously meaningful to me now to relieve the suffering of every little American out here, a cross section of whom we represent, and some tangible manifestation that this administration understands the kind of social carnage which they are generating by these very, very mean programs—a meanness that has been uncharacterized by any administration in modern times.

Especially at the same time, we seem willing and almost eager, which is something a lot of Americans do not yet understand but soon will, to squander the national sustenance on building bigger and better bombs, bullets, airplanes, and implements of destruction.

No one quarrels with a strong country—least of all me. However, when you look at the arsenal that this country has created up to now in our development and the enormous cost of that, then you begin looking in the face of the problems we are sitting here talking about. Measure that against a backdrop of a $1.6 trillion outlay in the next 5 years to do one specific thing in the national life. That seems to me to be off-course at the most generous estimate.

Let me correct the myth, if it should exist in this room right now, that defense spending creates jobs. It simply does not.

There is a net job loss to this Nation for every $1 billion invested in defense than if the same $1 billion were invested at selected places in the private sector.

We have the research to prove it; I have been through it. We are just absolutely satisfied that there is a net loss.

That being so, we cannot any longer walk down that alley willy-nilly—that this is one way to pump up the job market.

The way you pump up the job market in this country is to take care of those people who are the providers of jobs. That happens to be middle and small business in the United States of America. Conglomerates no longer do it. They are too busy making money investing in money and not in the productive process.

I think we have to take a hard look at that defense business and spend what it takes to shore up the identified aberrations—I will not even call them weaknesses—in our defense posture. We can do that at a cost that is inconsequential to the sums of money we are talking about now in the trillions.

I would urge anyone within reach of my voice to look hard and seriously at what we are doing to America on the alter of trying to defend it.

If we continue down that furrow far enough, we will have rendered the country indefensible if we spend double the money on implements of war, because a stable economically secure society is as essential to the national defense as any neutron bomb or anything else.

Senator Weicker. You are very eloquent. I mean that. I could not concur more with your last remarks.

Incidentally, do you have some documentation to back up what you were talking about—the creation of jobs in defense as compared to being put in the private sector? I would like to see that.

Mr. Winpisinger. We can provide it. Absolutely.

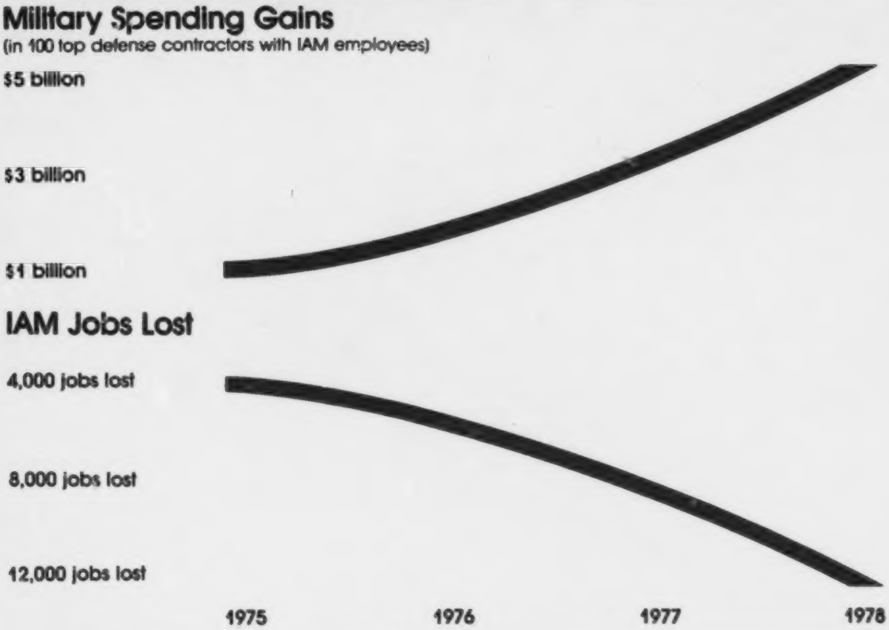
Senator Weicker. I would like to see that.

Mr. Winpisinger. We will make sure you get it.

[Subsequent information was received and follows:]

THE IMPACT OF MILITARY SPENDING ON THE MACHINISTS UNION

By Marion Anderson



COVER GRAPH: This graph shows the rise in military contracts among the 100 top military contractors which employ members of the IAM. The 12,500 IAM members which suffered job losses between 1975–1978 worked largely, but not exclusively, for these firms. (For details, see Appendix A and Appendix B.)

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January, 1979

INTRODUCTION

Since 1941, most Americans have believed that a high level of military spending is good for the economy. The facts seemed clear. We had the great Depression, the worst in modern history. Millions were unemployed. Then World War II came, and 11,000,000 young men and women joined the armed forces. Millions more went to work in military plants, and the Depression ended.

So, a simple conclusion was drawn: World War II ended the Depression, therefore, military spending creates jobs and is good for the economy.

Although the military budget goes up every year and is now at the highest level in U.S. history, unemployment remains at levels of six or seven percent in both Republican and Democratic administrations. So the proposition that military spending is good for the economy because it creates jobs has come under intense scrutiny.

This report first shows the impact of the military budget upon employment nationwide. It shows how many jobs are gained through military contracts and salaries and compares this figure with the number of jobs which would have been created if the tax monies going to the Pentagon had stayed in the taxpayers hands to be spent on consumer goods and services. Then the report focuses on the impact of the Pentagon's budget on Machinists Union members in terms of job opportunities gained or lost on a state-by-state basis.

The principal question asked in preparing this report was: Do IAM member gain or lose jobs as the military budget goes up?

There are two key questions which must be answered in analyzing the impact of military spending upon the Machinists Union. First: What is the impact upon Machinists working on civilian goods and services? Does the military budget increase or decrease their job opportunities? Second: What is the effect of the growing military budget upon IAM members working directly on military contracts? Are their job opportunities increasing as procurement contracts rise?

The answer to the second question is: as the military budget goes up, and procurement contracts rise, Machinists jobs in military industry steadily decline. In October, 1978, 88,000 IAM members were employed on military contracts either industrial or governmental. In 1975, that figure was 12,300 jobs higher. The drop can be seen clearly in defense dependent states like California and Washington. Much of this job loss can be attributed to technological development. As military industries become increasingly capital intensive, jobs decline.

SUMMARY

This study has found that far fewer Machinists Union members are employed in military production than has been reported. For at least a decade, it has been assumed that from 25% to 35% of the total IAM dues paying membership has been employed in military and military related work. That would mean roughly 185,000 to 260,000 IAM members working in military production. **This report finds that only 12.9% of the total IAM membership — 88,090 members — are engaged in military work.**

A finding of even greater significance is that in 30 states, many of them recipients of major military contracts, IAM members suffer a net loss of job opportunities when military spending is high. This is because the number of IAM jobs foregone in civilian goods and services because of tax monies going to the military exceeds the number of jobs generated by military contracts.

A Pentagon budget of $124 billion costs the Machinists over 118,000 civilian jobs. When the 88,000 jobs generated by this level of military spending are subtracted, the net job loss to the union is 30,000 jobs a year. (See Table 2, pg. 4.)

JOBS: A CASUALTY OF MILITARY SPENDING

Two separate research projects were required to complete this report. The purpose of the first was to determine the impact of the military budget upon employment nationwide. It resulted in a report by Marion Anderson released in 1978 by Senator Edward M. Kennedy called *The Empty Pork Barrel: Unemployment and the Pentagon Budget*. It showed that military spending costs jobs in every sector of the economy.

The Empty Pork Barrel documented that military spending at a rate of $78 billion a year is responsible for the annual loss of 907,000 jobs. Every additional $1 billion of Pentagon spending causes the loss of 11,600 job opportunities in the United States. The current $124 billion military budget is costing the jobs of 1,440,000 Americans.

It is a common sense conclusion based on the simple proposition that the same dollar cannot be spent in two different places at the same time. If the taxpayer's dollar is being used to support troops in Korea, it cannot simultaneously be spent by him to buy a new car or take a vacation. Professor Bruce Russett of Yale University did an analysis showing where Americans would have spent their tax money if it had remained in their pockets instead of going to the Pentagon. He found that each billion dollars paid in taxes for the Pentagon would have been spent in the following ways:

TABLE I

Expenditures Foregone By Sector Of The Economy For Each Billion Dollars Spent On The Military

$187,000,000	on services
163,000,000	on durable goods
128,000,000	on state and local government consumption
114,000,000	on residential structures
110,000,000	on producers' durable equipment
71,000,000	on non-durable goods
68,000,000	on non-residential structures
53,000,000	on transportation*
48,000,000	on federal civil purchases
25,000,000	on imports

*A separate regression analysis was run on transportation. This was substituted for Russett's regression on exports.

By applying these percentages to a given level of military expenditure, it can be determined how much money the Pentagon's budget siphons off from each sector of the economy.

The Empty Pork Barrel carries Russett's analysis a step further — from money never spent to jobs never created.

There are three steps to this analysis. First, it was determined how many fewer jobs there were in each of these sectors of the economy in every state when $78 billion of tax money was going to the Pentagon. Second, the number of jobs generated by military contracts and by stationing military personnel in each state was calculated. Finally, finding the difference between these sets of numbers, on a state-by-state basis, shows the net job loss or gain at the given level of military spending.

As indicated by Russett's Table I above, workers in services, durable goods, state and local government, and construction suffer the most in lost job opportunities when military expenditures are high.

A $78 billion military budget costs:

- 1,560,000 jobs in services, some of which would include airline and auto mechanics, flight attendants, baggage handlers and clerks;
- 1,011,000 state and local government jobs of which there are few in the IAM;
- 476,000 construction jobs;
- 663,000 civilian durable goods jobs with heavy concentrations of IAM members, especially in the metal working, machinery producing and transportation equipment industries.

TABLE 2

States Which Suffer A Net LOSS of IAM Jobs When Military Spending Is $124 Billion

State	Civilian Jobs Foregone	Military Jobs Generated	Net
1. Illinois	−21,300	+2,200	−19,100
2. Wisconsin	−5,100	+1,000	−4,100
3. Washington	−7,750	+4,200	−3,550
4. Pennsylvania	−6,750	+2,950	−3,800
5. Ohio	−6,550	+2,950	−3,600
6. California	−24,450	+21,000	−3,450
7. New York	−8,100	+4,750	−3,350
8. Michigan	−2,400	+200	−2,200
9. Minnesota	−2,800	+50	−2,750
10. Indiana	−1,950	+130	−1,820
11. New Jersey	−2,000	+300	−1,700
12. Tennessee	−1,450	+550	−900
13. Iowa	−1550	+800	−750
14. Montana	−750	+30	−720
15. Kentucky	−1,000	+200	−800
16. Maryland & D.C.	−1,200	+700	−500
17. Colorado	−450	+80	−370
18. Arkansas	−550	+200	−350
19. Oregon	−1,450	+1,150	−300
20. Massachusetts	−1,650	+1,400	−250
21. Maine	−200	+40	−160
22. W. Virginia	−450	+300	−150
23. Alaska	−80	0	−80
24. Nebraska	−250	+180	−70
25. Nevada	−40	0	−40
26. Wyoming	−25	0	−25
27. Vermont	−55	+30	−25
28. Idaho	−40	+20	−20
29. Delaware	−20	0	−20
30. S. Dakota	−21	+20	−1

States Which Have A Net GAIN of IAM Jobs When Military Spending Is $124 Billion

State	Civilian Jobs Foregone	Military Jobs Generated	Net
1. Missouri	−3,500	+12,900	+9,400
2. Texas	−2,300	+4,000	+1,700
3. Connecticut	−3,600	+5,750	+2,150
4. Georgia	−1,300	+3,250	+1,950
5. Arizona	−400	+1,950	+1,550
6. Hawaii	−150	+1,700	+1,550
7. Virginia	−800	+1,900	+1,100
8. New Mexico	−250	+1,300	+1,050
9. N. Carolina	−150	+1,050	+900
10. Mississippi	−200	+1,000	+800
11. Alabama	−900	+1,600	+700
12. Florida	−1,300	+2,000	+700
13. Kansas	−1,150	+1,750	+600
14. Oklahoma	−450	+800	+350
15. S. Carolina	−150	+400	+250
16. New Hampshire	−80	+300	+220
17. Utah	−150	+300	+150
18. Rhode Island	−500	+550	+50
19. N. Dakota	−20	+40	+20
20. Louisiana	−250	+260	+10

Machinists Total Job Loss −30,000

Workers in construction, the food and clothing industries, state and local government, services, automobile and other durable goods production, and the light and heavy industries which service the above businesses and occupations suffer when the Pentagon's budget is high.

When military spending is only at $78 billion level, far lower than today's, it costs 3,253,000 civilian industrial and service jobs. The jobs generated by military contracts and by hiring soldiers, do not nearly make up the difference.

Every state in the country suffers a net loss of industrial jobs when military spending is high. Even Texas and California, despite their large military contracts, suffer a net loss of civilian industrial, service, and state and local government jobs. California is currently losing over 500,000 jobs in civilian industry, police, fire protection, and teachers. Texas loses over 200,000 civilian industrial and service jobs.

Spending money on either military industry or on military personnel increases the country's unemployment. If a billion dollars were transferred from military industry to civilian industry, 14,000 more jobs would be created. If a billion dollars were used by state and local governments to hire teachers, police and firemen, 30,000 more jobs would be created than if the same billion dollars were used to hire military personnel. Either way, the economy gains and unemployment goes down.

TABLE 3
Jobs Created Per Billion Dollars Of Expenditure

Jobs created by:	**If spent to create jobs in industry**	**If spent to create jobs in government**
$1 billion spent in civilian sector	59,000 jobs	88,000 jobs*
$1 billion spent in military sector	45,000 jobs	58,000 jobs
Jobs foregone by spending on the military	**14,000 jobs**	**30,000 jobs**

*State and local government

JOB LOSS FOR THE MACHINISTS

What happens to the membership of the Machinists Union?

The second part of the research was to determine the impact of the Pentagon budget upon the IAM.

Two steps were necessary: First we had to determine how many Machinists jobs were foregone in durable goods, non-durable goods, services, construction, and state and local government. Then we had to find out how many members of the union were actually involved in working on any kind of military contract.

The first part of the analysis was similar to the one done for *The Empty Pork Barrel*. We determined on a state-by-state basis, how many fewer jobs there were for Machinists members when military spending is at the current level of $124 billion. We found that this level of spending was having a heavily negative impact upon civilian industries and thus upon IAM members.

There are today, over 118,000 fewer jobs for IAM members in civilian industry because of the military budget. These are the civilian jobs foregone when people are heavily taxed to pay for the military and are unable to spend the money upon their own needs.

The members of the International Association of Machinists are overwhelmingly involved in the production of durable goods and services. These are two of the hardest hit categories of the economy when military spending is high.

When taxpayers feel pressed by high taxes and are worried about inflation, they will put off their purchases of durable goods. This causes stores to cut back on inventories, manufacturers to buy less machinery, and Machinists to see their job opportunities diminish.

Service industries are also hard hit. People have to buy food and clothing, they have to pay their fuel bills. But they do not have to take a vacation they had been looking forward to, they put off servicing their car, and families decide they cannot afford a plane trip to see each other.

All of these individual decisions to not buy, to not take a vacation, and to not add to plant and equipment, cost jobs — Machinists jobs. (See Table 2, pg. 4.)

After determining the number of IAM civilian jobs foregone, we had to find out how many IAM members were working on military contracts.

The Research department sent out two questionnaires to all of the Districts and Locals to get this information. These questionnaires were followed up with hundreds of phone calls to the Districts and Locals which had not responded. We heard from over 93% of the membership and estimated the military contract jobs in the remaining 7%.

Currently 88,000 members of the IAM are engaged in military industrial work or other kinds of military work. This is 12.9% of the total membership.

When the 118,000 civilian jobs foregone are combined with the

88,000 military jobs created, the net job loss to the Machinists union is 30,000 jobs. This means that every time the Pentagon's budget goes up, jobs disappear for members of the IAM.

Even the members who are currently working on military contracts suffer lessened job opportunities, for if there are fewer Machinists' jobs available nationwide, a member who is dissatisfied with his present job, who wants to move, or who wants to negotiate his wages upward has just that much less opportunity to do so. Businesses spending less on capital goods, people buying fewer cars, both business and government allowing our railroads to decline, all of these decisions cause a drop in job opportunities, pay, and mobility for union members.

INFLATION

Military spending not only generates unemployment, it is highly inflationary. About half of the budget controlled by Congress goes for military purchases and salaries. It is the most inflationary form of federal spending. There are several reasons for this:

First: most military contractors produce on a cost-plus basis. They have no incentive to improve efficiency and cut waste. Contractors get guaranteed profits no matter what the costs incurred. As their profits are calculated as a percentage of their costs, their basic incentive is to increase their costs and thus their profits.

A recent report by the General Accounting Office* showed that 55 major Pentagon projects were initially estimated to cost $125 billion. As of September, 1978, the total cost of those projects was put at $210 billion. The GAO reported that 33% of the $85 billion increase can be attributed to inflation. The other $57 billion is the clear result of waste, bad planning and mismanagement. This $57 billion cost the average American family $1140.

Second: resources are used in the production of military hardware and services at the expense of their availability to the civilian sector. Bombs, missiles, submarines, and tanks cannot be bought by the public. They add nothing to the supply of consumer goods and cannot be either reused or utilized in the production of other goods. Therefore, the stock of civilian goods and services is reduced and the market prices of raw materials is bid up thus pushing up prices along the production chain for all goods and services.

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*Systems Acquisitions Report, Quarterly Update, General Accounting Office, Washington, D.C., Sept. 30, 1978.

Third: the federal government must borrow money in the open market to finance the military. This not only adds to the federal debt, it adds to the interest costs of servicing that debt, and it bids up interest rates - the price of money - which everyone has to pay.

Fourth: contractors themselves enter the money markets to borrow capital for military production. This reduces the availability of capital for the civilian sector and gives an additional boost to interest rates.

The inflation hits IAM members in two ways. The value of members' pay checks is reduced as their raises do not keep pace with the inflation. Union members are then forced into a cruel spiral in which if they bargain for higher wages which anticipate price rises, they are blamed for causing the inflation. But if they do not anticipate coming price rises in the bargaining sessions, they take a yearly pay cut.

IAM members are also hit by the inflation through their jobs. As purchases of durable goods and services are the first things that people put off, job opportunities are diminished. When the interest rate goes to 12% or 13%, the average businessman is going to think long and hard before investing in new plant and equipment.

Machinists, like other union members, are caught in the crunch: higher prices, fewer jobs, and more blame placed on unions for causing the problems.

THE UNDERMINED ECONOMY

The preeminence given to military industry and technology over the last three decades, has had a delayed but serious impact upon the civilian industrial economy. In stark contrast to the enormous sums allotted over the years to military technology, civilian technology has been starved for capital and thus for talent.

Over half of the U.S. scientists and engineers have been working on military and space contracts. This has meant that this great pool of talent has not been available to work on civilian commercial designs and applications of new technology. There is no mystery why the Germans, Japanese, or Swedes have pulled equal to or ahead of us in steel, machine tools and electronics. Virtually all of their scientists and engineers are working on civilian technology.

As the productivity of our trade rivals rises rapidly while ours stagnates, the costs of our goods, but not their quality rises. This means that it becomes cheaper for many firms to build factories abroad or to import finished materials and components. These business decisions also export jobs. The control may still rest with an American management, but the jobs have been moved to Germany, Taiwan, or Korea.

People have little sense of the magnitude of the investment in the Pentagon in relation to other investments in the society. *During the 1960's and 1970's the Pentagon spent more money than the after tax profits of all U.S. corporations combined.* This includes ATT, ITT, General Motors, Ford, Sears - all of them. This is where our taxes have been going, and the results have been the deterioration of American industry and therefore both inflation and unemployment.

The capital siphoned off through taxes to the Pentagon has meant that it is unavailable for civilian enterprises. Less capital investment means fewer jobs. Important areas of the economy are severely undernourished. Railroads, mass transit, and the solar energy industry are all areas which need massive infusions of capital both because of declining oil supplies, and to enhance the quality of life while depolluting the environment.

As the publication of the Machinery and Allied Products Institute stated: "This country cannot count on further major devaluations to maintain its competitive posture in world markets. If the U.S. is to continue its position of political and economic leadership in the world and to maintain the world's highest standard of living, an improvement in productivity is crucial.

"The evidence....strongly supports the proposition that productivity is dependent upon the relative level of fixed investment. We must intensify our efforts to expand and modernize U.S. industrial capacity. This will require a high level of capital formation."

New taxes are not needed to bring about badly needed change in our country. The federal government is taking enough. But some of our taxes can be productively rechanneled.

CONVERSION

In order for any conversion program to be successful, there has to be both an actual transfer of capital from military to civilian production, and a parallel transfer of skills.

There are four areas of the civilian economy which need large amounts of capital and which need it now. They will generate far more jobs per $1 billion dollars spent than if the money remained with the Pentagon and they will use the skills of members now employed in military industries. Investment in these industries will mean more jobs for members of the Machinists.

Philip Weber, in his excellent new report, *Jobs to People-Planning for Conversion to New Industries,* suggests four key industries for massive upgrading or development: railroads, mass transit, solid waste disposal, and solar energy. The development of all of these industries would result in an upgrading of our environment, increased independence as we would not need so much Middle Eastern oil, and more jobs utilizing the skills which defense workers have developed.

Railroads – 474,000 more jobs per year

An investment of $7.7 billion a year in railroads, both in upgrading track and station facilities, and in building rolling stock, will generate 164,000 jobs each year for the next fifteen years. A substantial number of these jobs would be for members of the IAM. For as Webre states in his report, "The 1970 census indicates that in the manufacturing of rolling stock, over 25% of the workers are craftsmen, machinists and tool and die makers. 40% are operatives (of precision instruments, etc.) This distribution is ....roughly comparable to the skill spread of defense workers."

164,000 jobs per year would be in direct job creation. There would be an additional 310,000 jobs generated every year in indirect job creation.*

Mass Transit – 192,000 more jobs per year

Mass transit could easily absorb $3.1 billion a year for the next fifteen years. If major new subway systems were built, this amount would skyrocket. Using the money for buses, light rail (a modern trolley) heavy rail (usually some form of subway), and commuter rail would generate 78,000 jobs per year in direct and 114,000 jobs in indirect employment.

About half of this sum would go into manufacturing, the other half into construction. The trades involved, says Webre, would include many IAM members as they would be "craftsmen, mechanics, millwrights, operatives, welders, and other technical workers."

Resource Recovery Systems – 40,000 more jobs per year

As Americans are generating increasing amounts of trash, and cities are running out of room for landfills, resource recovery systems are becoming increasingly important. Their attractiveness is increased by the fact "that each ton of garbage has more energy than a barrel of oil."

Although the resource recovery industry is not fully developed, "the skills and equipment to manufacture much of the needed equipment can be found in any large and well equipped machine

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*All estimates of job creation in railroads, mass transit, resource recovery, and solar power are based upon the table Summary of Conversion Project Employment Estimates from Philip Webre's forthcoming report *Jobs to People*. Specific quotations in this section on conversion are also from this report. It is to be published by the Exploratory Project on Economic Alternatives, Washington, D.C.

shop. Therefore, many defense facilities should be adaptable to the work."

An expenditure of $1.4 billion a year for 12 years would generate 22,000 direct jobs in resource recovery and 18,000 jobs in indirect employment. It would also have the effect of stimulating new businesses in a large variety of locations as resource recovery plants will be needed in such a large number of counties and cities.

Solar Energy - 71,000 more jobs per year

Solar energy development has caught the imagination of the American people, and Congress has begun to respond. But the large capital investments necessary to make equipment marketable at a price the average American can afford is yet to come.

IAM members would be heavily involved in the various types of solar equipment manufacture. A substantial number of IAM members would be needed to make wind generators. The large scale manufacture of wind generators would "increase the need for assemblers, electricians, mechanics, winding machines and precision machine operatives. Manufacture of the generator's extensive gear works would require metal workers and machinists. Electrical and electronic equipment would also be needed. Helicopter plants would be well suited to the manufacture of windmill blades."

Manufacturing solar collectors "for use in heat engines, or for industrial, commercial or residential heating and cooling, would generate a need for sheet metal workers and assemblers." People experienced in work with glass and plastics would be needed as well as heating and cooling equipment specialists and other specialized mechanics.

A $2.1 billion per year investment for the next 7 years, would produce 19,000 direct jobs and 52,000 indirect jobs in the solar industry alone.

A total of $14.3 billion per year invested in these four industries would generate over 777,000 jobs per year. They would draw heavily on the skills which IAM members and others who have worked in military industries have developed. But they would be working in a relatively stable, expanding civilian market.

Legislation to protect workers' employment has been written and is being promoted by the IAM. Its passage can be the beginning of a major shift in this country as some of the brains, the skills and the capital long devoted to armaments are turned to the civilian commercial pursuits which have historically employed our people and supported both our democracy and our standard of living.

CONCLUSION

No nation can afford to be undefended. But neither can any nation afford to indulge in wasteful procurement processes which encourage inefficiences, bad management, and extravagent overruns.

The foundation of a nation's security is its economic strength. Practices which undermine this strength diminish our country's security. We can no longer afford to siphon off to the Pentagon such large sums of taxes that our civilian industries become non competitive in the world market and hundreds of thousands of our citizens are thrown out of work.

This report has suggested a conservative figure to cut the Pentagon's budget - $14.3 billion. This sum transferred to job generating, secure civilian industries, would begin the crucial process of conversion.

This sum is substantially less than the hard pressed American taxpayer has been promised since 1970. During the war in Vietnam we were promised a $20 billion "peace dividend" when the war was over. When the war ended, the military budget was $80 billion. Four years later while the country was at peace, the Pentagon was getting $105 billion. Two years after President-elect Carter had promised an ***annual*** reduction of $5-$7 billion, he was asking for $127 billion.

The $14.3 billion needed for a serious start on conversion is less than 14 months' *increment* for the Pentagon. This is the capital which could give us a major start on solar energy, bring our railroads and mass transit into the late twentieth century, reduce our dependence on foreign oil and give hundreds of thousands of our people jobs.

It is clear from this study that the money is there. Our Congressmen, Senators and President must be told that we want jobs, job security, an end to inflation, and a reduction of the Pentagon's swollen budget by transferring the unneeded money into job creating activities in the civilian sector.

APPENDIX A

Local Lodges which had a portion of their membership working on military industrial contracts or military governmental contracts in October, 1978

State	Local Lodge	District	Number of Members Working on Military Contracts	Number of Members Working on Civilian Contracts
Alabama	291	178	41	171
	1325	92	291	0
	1632	75	145	425
	2003	75	1097	0
Arizona	715	49	364	0
	763	49	339	0
	933	+	1133	0
	2282	+	44	0
Arkansas	502	+	100	0
	1948	33	8	187
California	68	115	34	1642
	311	94	853	1960
	364	115	30	369
	442	+	40	0
	562	93	1690	995
	575	94	420	940
	720B	720	286	428
	720D	720	38	46
	720E	720	135	421
	720J	720	643	963
	720L	720	145	0
	726	50	119	0
	727A	727	456	399
	727B	727	1050	919
	727C	727	671	586
	727D	727	469	411
	727E	727	463	404
	727F	727	14	349
	727M	727	127	111
	727P	727	673	588
	727Q	727	278	243
	739	56	483	0
	749	120	175	0
	755	50	765	1248
	758	727	537	476
	812	+	18	0
	821	120	150	257
	824	115	207	1032
	906	120	224	99
	946	+	702	87
	964	120	235	627
	1004	727	61	746
	1125	50	423	1212
	1233	120	1057	0
	1327	115	8	1033
	1518	115	324	1558
	1528	115	78	804
	1600	94	257	506
	1638	727	49	43
	1785	+	417	0
	2024	720	800	533
	2025	720	186	124
	2027	720	11	0
	2193	50	112	334
	2215	50	1493	0
	2218	50	66	72
	2225	508	850	94
California (continued)	2226	508	287	32
	2227	508	959	0
	2228	508	905	0
	2230	508	174	0
	2231	508	108	12
	2242	+	124	0
	2644	120	100	0
	2659		528	0
Colorado	750	86	40	96
	2361	70	72	139
Connecticut	700	91	389	905
	707	91	564	1315
	743	91	472	1103
	902	170	21	401
	1746A	91	646	1507
	1746	91	2053	4790
	1971	+	1238	0
Florida	42	75	18	164
	192	+	309	0
	570	+	83	44
	610	166	163	0
	971	100	861	163
	1323	166	128	0
	1630	+	298	0
Georgia	709	+	3071	1366
	2344	+	87	0
Hawaii	1245	151	65	1214
	1589	151	84	0
	1998	+	1536	0
Idaho	1712	+	13	0
Illinois	49	8	43	2127
	50	8	537	3586
	81	102	566	0
	660	9	249	4478
	851	55	20	4801
	852	123	87	391
	930	101	16	309
	1202	108	79	1442
	1269	101	49	938
	1290	101	75	174
	1629	132	37	46
	1714	8	130	325
	1832	101	119	538
	1856	167	6	657
	2042	167	2	2
Indiana	2647	72	125	502
Iowa	388	102	165	62
	1318	134	340	65
Kansas	733	70	1112	2139
	834	70	414	2485
	1683	70	55	106
	2328	70	154	401
Kentucky	859	+	107	0
Louisiana	37	+	184	335
Maine	1256	99	38	297
Maryland	1561	+	165	0
	2424	+	478	0

State	Local Lodge	District	Number of Members Working on Military Contracts	Number of Members Working on Civilian Contracts
Massachusetts	264	38	517	1550
	1359	64	11	11
	1836	38	550	367
	2175	+	124	14
Michigan	218	158	3	259
	1523	117	11	212
	1618	158	10	58
	2597	97	145	218
Minnesota	459	77	9	2883
Mississippi	1133	73	951	0
Missouri	41	9	384	2515
	42	71	14	1339
	314	71	2171	0
	777	9	169	4309
	837A	837	2146	108
	837B	837	3398	179
	837C	837	2389	126
	837D	837	1616	85
	837E	837	331	83
	990	71	295	64
Nebraska	31	+	147	695
New Hampshire	836	109	199	0
	2503	109	61	60
New Jersey	176	1	109	0
	703	15	62	62
	974	+	8	8
	1911	15	80	70
	2407	15	11	148
	2581	1	49	0
New Mexico	794	183	280	281
	1689	183	154	0
	2515	+	831	0
New York	93	6	9	186
	588	6	73	657
	630	76	52	471
	761	137	102	748
	784	157	58	0
	838	+	25	270
	1470	15	604	603
	1529	+	543	1268
	1558	65	64	190
	1607	+	199	1789
	1669	157	479	0
	1875	157	12	590
	1972	15	10	169
	1987	+	2228	113
	2112	76	44	398
	2404	76	3	48
	2562	58	1	8
N. Carolina	1859	110	72	0
	2296	110	274	0
	2297	110	599	0
	2316	110	14	0
	2554	110	48	13
Ohio	55	52	210	195
	148	82	25	482
	233	54	185	2036
	427	52	76	178
	439	54	100	1224
	729	34	133	111
	912	34	949	10
	1038	52	4	807
	1136	52	67	136
	1282	139	5	152
	1349	129	94	796
Ohio (continued)	1581	88	11	217
	1699	88	41	121
	1711	139	8	248
	1849	139	62	61
	2065	82	206	0
	2284	82	124	0
	2333	82	362	0
	2535	13	176	264
	2572	59	1	197
Oklahoma	898	+	749	260
	960	+	8	0
	2252	11	10	563
Oregon	63	24	1085	1669
Pennsylvania	52	63	192	416
	140	98	55	499
	175	98	95	1014
	687	1	330	0
	847	128	600	0
	938	116	66	298
	1092	152	378	917
	1167	98	2	164
	1328	65	62	249
	1400	98	392	664
	1582	63	32	237
	1729	128	14	130
	1890	152	18	37
	2178	106	36	146
	2346	1	28	0
	2463	152	10	140
Rhode Island	119	64	17	0
	147	64	50	401
	587	64	401	0
	1142	64	12	1062
	1560	64	13	121
	2098	64	12	104
S. Carolina	694	+	313	0
	2260	+	45	7
Tennessee	735	155	182	1097
	1501	169	333	0
Texas	730	+	25	93
	776A	776	1523	0
	776C	776	1522	0
	823	31	63	243
	1025	177	44	0
	1255	119	340	34
	1764	126	130	33
	1786	37	349	0
	2049	+	43	0
	2121	776	252	0
	2504	126	1	103
Utah	2261	+	298	0
Virginia	39	74	959	0
	97	74	433	0
	441	74	411	0
Washington	79		403	2805
	282	160	412	154
	289	+	19	2418
	751	751	3242	14304
	1103	160	52	398
W. Virginia	818	136	182	183
	1027	+	101	0
Wisconsin	908	10	25	113
	106[illegible]	10	356	535
	20[illegible]6	10	394	0

NOTE: In the case of each returned questionnaire or telephone contact, the Local Lodge membership was compared with the GST figures. In case of discrepancies, the GST figures were used and the proportions of members working on military and civilian contracts were adjusted accordingly.

APPENDIX B*

Firms Which Are Among The 100 Top Military Contractors Which Employ Members of the IAM

Firm	1975 Military Contracts	1977 Military Contracts
AT&T	$ 510,100,000	$ 456,800,000
Atlantic Richfield	72,900,000	
Avco Corp.	93,200,000	109,600,000
Beech Aircraft		84,300,000
Bendix	180,500,000	205,700,000
Boeing	1,560,800,000	1,579,900,000
Chamberlain Mfg.	70,400,000	127,800,000
Chrysler	282,600,000	619,900,000
Cutler-Hammer	49,000,000	75,700,000
Day & Zimmerman	67,100,000	79,400,000
E-Systems	100,100,000	160,000,000
FMC	144,700,000	244,900,000
Fairchild Ind.	191,700,000	429,300,000
Ford Motor Co.	259,700,000	351,900,000
General Dynamics	1,288,800,000	1,371,500,000
General Electric	1,264,200,000	1,519,600,000
General Foods	46,300,000	65,800,000
General Motors	[illegible]0,400,000	380,100,000
GTE	165,2[illegible]	199,700,000
General Tire and Rubber	169,000,000	187,100,000
Goodyear	135,000,000	140,000,000
Gould	100,600,000	95,300,000
Harsco Corp.	91,500,000	177,800,000
Honeywell	291,500,000	456,700,000
Hughes Aircraft	1,026,000,000	1,093,400,000
ITT	233,400,000	250,500,000
Kaiser Ind.		115,800,000
Water Kidde & Co.	80,800,000	
LTV	366,200,000	295,900,000
Lear Siegler	56,300,000	101,600,000
Litton Industries	1,038,100,000	609,300,000
Lockheed	2,080,300,000	1,573,400,000
McDonnell Douglas	1,397,900,000	2,574,000,000
Mobil Oil	204,000,000	188,800,000
Norris Industries	106,900,000	109,000,000
Northrop	620,300,000	1,046,700,000
Pan Am	95,700,000	139,500,000
Protor and Gamble	44,700,000	61,700,000
RCA	286,100,000	364,000,000
Raytheon	680,600,000	1,040,900,000
R.J. Reynolds	154,000,000	
Rockwell	732,300,000	1,479,900,000
Signal Companies	90,000,000	118,300,000
Singer Corp.		350,100,000
Sperry Rand	437,100,000	651,500,000
Standard Oil (Cal.)	301,400,000	296,500,000
Standard Oil (Ind.)	112,300,000	123,200,000
TRW	286,200,000	361,300,000
Teledyne	236,100,000	304,800,000
Texaco	226,500,000	95,000,000
Textron	545,900,000	454,700,000
Thiokol Corp.	100,500,000	144,800,000
Todd Shipyards		468,400,000
United Technologies	1,407,400,000	1,584,700,000
Westinghouse Electric	314,500,000	802,100,000
	$20,786,800,000	$25,918,500,000

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*Detailed procurement contract information by firm was not available for 1978 at the time of publication. However, general data obtained from the Office of the Comptroller of the Secretary of Defense indicated that procurement contracts rose substantially in 1978. So the $5 billion figure for contract rise shown on the cover graph is conservative.

AN ENQUIRY OF THE IMPACT OF ARMAMENT PRODUCTION ON EMPLOYMENT

METALWORKERS UNIONS AND THE ARMAMENT INDUSTRY

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AN ENQUIRY OF THE IMPACT OF ARMAMENT PRODUCTION ON EMPLOYMENT

Published by
INTERNATIONAL METALWORKERS' FEDERATION
54 bis Route des Acacias
1227 Geneva (Switzerland)

PRESIDENT: EUGEN LODERER
GENERAL SECRETARY: HERMAN REBHAN

IMF CENTRAL COMMITTEE 18–19 OCTOBER 1979, VIENNA

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INTRODUCTION

IMF General Secretary, Herman Rebhan

The initial IMF report on "Metalworkers' Unions and the Armament Industry" was drawn up on the basis of questionnaires to affiliated organisations for the Executive Meeting in Madrid, March 1979.

The Executive Committee felt that this topic was so important that it should be brought up to date and submitted to the Central Committee in Vienna with a view to giving it the widest circulation possible. The Secretariat has therefore made the necessary inquiries to bring the report up to date and it is now presented for your consideration.

METALWORKERS UNIONS
AND
THE ARMAMENT INDUSTRY

An Enquiry of the Impact of
Armament Production on Employment

February 1979

METALWORKERS UNIONS AND THE ARMAMENT INDUSTRY

An Enquiry of the Impact of Armament Production on Employment

I HUMAN AND SOCIAL COSTS OF GENERAL MILITARY SPENDING

☐ *The Madness of Destruction*

In our imperfect world a defence system is unfortunately a necessity. Despite disarmament discussions we are still living in an arms race environment. Weapons are becoming even more powerful and sophisticated, leading to inescapable technological competition in a world which has reached a point of self-destruction and where additional military expenditure no longer implies increased security for anyone. The endless scramble for arms can only be reversed through universal disarmament and effective controls.

In 1976 total spending covering all aspects of a military budget, both armies and arms procurement, reached, according to the Stockholm International Peace Research Institute, $ 350,000 million. On this basis total military expenditure can now easily be estimated at around $ 400,000 million. Another source, the United States Arms Control and Disarmament Agency, indicates total military spending of $ 400,000 million in 1976 which would hint at a present total yearly figure of roughly $ 500,000 million. (*See Chart I*)

The greatest part of most military budgets are well guarded secrets, especially in communist countries and military regimes.

However roughly assessed, what do such gigantic sums represent in real terms? Military budgets equal the annual income of 1,800,000,000 people in the thirty-six poorest nations. In two days the world spends the equivalent of a year's budget for the United Nations and its specialized agencies on arms.

Since the Second World War there have been 133 armed conflicts in which 88 countries were involved and which cost 25 million human lives.

Throughout the world an estimated 60 million people are engaged in military and related activities, of which approximately 28 million are civilians working in military establishments or providing goods and services to the army. Despite enormous advances in military technology, the armed forces have also expanded. This means that more soldiers are in possession of increasingly powerful weapons and that the enormous overkill capacity is leading to a considerable waste of resources. (*See Chart II*)

☐ *Socially Negative Effects*

Military spending reaches in the world average $ 81 per person whilst total educational expenditure remains 7 per cent less. Average health expenditure is only $ 44 per person and development aids amount to $ 6 per capita. Military spending is to the detriment of basic human needs including housing, restricts general consumption and has a direct effect on inflation. (*See Chart V*)

Defence budgets generate purchasing power for individuals and corporations without producing an equivalent supply of economically useful goods for the civilian market. The excess of disposable income over supply and the concentrated military demand on some goods and skills build up the process of permanent inflation.

☐ *Geographical Concentrations of Military Spending*

Military expenditure is highly concentrated, almost 75 per cent over six countries. According to latest figures furnished by the United States Arms Control and Disarmament Agency, USSR now heads the list with $ 127,000 million followed by USA with $ 91,000 million, China $ 34,400 million, Western Germany $ 16,000 million and France $ 14,200 million. (*For proportion of military spending in relation to Gross National Product in individual countries, see Table X*)

In the last fifteen years the tendency has been for developing countries to greatly increase their military outlay to $ 90,700 million annually or roughly 22 per cent of the world total. Their arms imports expanded to a level of more than $ 7,000 million a year.

Oil rich Middle East countries are main arms consumers but even poor non-oil developing countries spent, in 1975, $ 4,000 million on imported weapons, laying a severe burden on their trade balance. (*For developing countries arms imports and economic aid, see Chart VI*)

☐ *A Grave Set-back for Developing Countries*

In developing countries the diversion of government budgeting expenditure for military purposes impedes economic growth more than anywhere else, delaying basic social progress. Adequate food and safe water are essential to health, yet 500 million people in deprived regions are chronically hungry and 1,400 million do not have access to drinking water in a world able to spend $ 400,000 million annually for bellicose and defensive purposes.

In this connection it is interesting to note that in 1974 already Iran was world's 7th in rank for military expenditure with $ 6,052 million but only 109th in rank as far as population per hospital bed was concerned.

II THE SCOPE OF ARMAMENT PRODUCTION

☐ *Arsenals in the World*

The arms business' turnover — as far as armament production for government orders is concerned — is overwhelming. It reached, in 1976, an annual figure of $ 80,000 million. (*For armament production in various sectors and countries, see Table IX*)

The total weapon inventory for world defence and destruction is frightening:

- 124,000 tanks + 12,400 combat ships + 35,000 combat aircrafts,
- nuclear weapons representing 50,000 million tons TNT equivalent,
- 50,000 atom bombs are in stock,
- 20 nations have nuclear power reactors and could produce thousands of nuclear bombs,
- 1,386 military satellites have been launched in the last twenty years (1957 – 1977).

At the end of the Second World War only five countries, the two superpowers and Great Britain, Canada and Sweden, disposed of capacities for development of heavy and sophisticated war equipment such as tanks, aeroplanes and battle-ships. Today more than thirty countries have own weapon producing facilities and a still greater number can build armament goods by licence. It is feared that this proliferation of armament production will produce new waves in the armament race.

☐ *The Role of Research and Development*

In this constant arms race between nations, research and development is decisive. Made up of an "army" of half a million scientists and engineers these activities devour $ 25,600 million in public funds. Although this has certain technological spin-offs for peaceful purposes, it handicaps other more vital research and greatly needed investments in the social fields, particularly if one considers that 40 per cent of all public research and development funds are absorbed for military purposes.

☐ *2.8 Million Metalworkers in Armament Production*

The IMF study on armament production based on a questionnaire to affiliates provides enough basic information to conclude that there are roughly 2.8 million workers in the free world.

Most workers in military production are employees of large corporations, either under government military contract work in private companies as in the USA, the Federal Republic of Germany, Switzerland, Sweden and the Netherlands or now state-owned as in Great Britain and Israel. Certain military supplies such as ammunition are usually produced in plants under direct state control.

The structure of military production in France is one of the most explicit. Production is carried out in three sectors: military state establishments, largely state-owned enterprises also working for civilian purposes and private corporations. Armament activities in all these sectors are under the control of the "Armament Delegation" which directly depends on the Ministry of Defence. Its tasks are mainly to finance and orientate research and development, to train specialized technicians and workers and to promote exports.

III ARMS EXPORTS

☐ *Size and Nature of Arms Trade*

World arms trade involves many secret transactions, triangular dealings, speculation, ruthless profiteering as well as big power politics. Accurate data on exports can hardly be expected, only assumptions which put total world arms trade at $ 24,000 (*See Chart III*)

Often the pushing of arms exports is motivated by expensive research and development which requires a sharing of the cost burden among as many buyers as possible. The "technical imperative" is a promoting factor of world arm trade.

Indicative for this trade among industrialized countries is the US sale of armament to its NATO allies, Japan, Australia and New Zealand, for an amount of $ 1,900 million.

☐ *Shocking Arms Exports to Developing Countries*

Whilst the high armament budgets of the industrially advanced countries are largely used for national production, developing countries continue to be the best customers of the arms industry in East and West. Their imports of arms reach a value of between $ 15,000 million and $ 20,000 million annually and make up approximately 75 per cent of total worldwide exports. Apart from slight fluctuations over the years, USA furnish about 40 per cent, USSR 35 per cent, France 6 per cent and Great Britain 5 per cent of these exports. Another important supplier from Western Europe is Italy and from the Eastern Bloc countries notably Czechoslovakia, also Israel sends armament to developing countries.

A considerable proportion of armament exports is determined by political tensions and developments within conflict areas; such supplies are the most hidden. An example of such export operations is the supply by air and sea of roughly 120,000 tons of military equipment in the early part of 1978 by the Soviet Union to ten African States. Ethiopia alone received 61,000 tons of these goods including aeroplanes, helicopters, weapons and vehicles. According to reports from the Middle East, the USSR furnished military equipment in the amount of $ 8,000 million to the conflict zones of this area and Africa.

☐ *Export Limitations*

More than a year ago direct negotiations began between USA and USSR for a common limitation of exports of conventional weapons. A good climate at the beginning of these negotiations rapidly deteriorated due to political events, so hope has vanished to achieve an effective agreement for export limitation. It also appeared that binding commitments between USA and USSR would not have any restrictive influence on the delivery of arms from their countries, including Europe, to developing countries. (*For national export limitations, see Table XII*)

☐ *Armament – A Risky and Small-scale Job Supplier*

Armament exports show big fluctuations. An example is Switzerland. Despite the fact that its arms exports, due to obligations imposed by neutrality, are mainly to countries which can be considered stable, these exports dropped by almost 15 per cent in 1974 then more than doubled over three years but fell again by 17 per cent in 1978. (*See Chart IV*)

Such fluctuations under prevailing industry structure unavoidably affect employment and there is a danger in any country that armament restrictions are stretched or side-stepped in the search for the necessary exports.

The role of arms exports should not be overrated as an employment creating factor. In the Federal Republic of Germany, which ranks among important arms suppliers, these shipments amount to only 0.71 per cent of the entire export trade or 4 to 5 per cent of total armament production, as in Great Britain. In Switzerland where a considerable part of arms exports are managed by a rapidly growing multinational company, the percentage of these exports in relation to total trade dropped from 1.2 to 1.02 per cent in 1978. In the case of these countries it should be possible to decisively improve employment security rather by expansion of civilian production than an engagement in the export arms race.

Drastic cut-backs in the risky armament business will always threaten employment. A recent example is the expected cancellation of Iranian orders. This is likely to amount to a loss of orders of $ 8,000 to $ 10,000 million to the American armament industry and $ 3,000 million to the Europeans.

It is characteristic for most enterprises in the armament industry to develop secondary production. In this connection evidence proves that use of resources in military sectors tends to generate less employment and exports than would an equivalent amount of investment for production of civilian goods in the same industry. (*See Chart VIII*)

IV MULTINATIONAL DEVELOPMENTS IN THE ARMAMENT INDUSTRY

☐ *Groupings of Main Producers and Co-production*

A considerable number of multinational companies, major producers in various metal sectors, are engaged in the armament industry. International groupings in different fields of armament technology are steadily growing. This development is favoured by efforts to standardize armament systems, on a level such as the North Atlantic Treaty Organization – NATO, and by the pooling of resources to meet the astronomical costs of modern armament technology.

Big armament projects lead to a growing concentration in a sector such as the European aerospace industry. Many producers engage in multinational cooperation in the form of special groupings. Typical for this development is Euromissile, grouping Aerospatiale, France and Messerschmitt–Bölkow–Blohm (MBB), the Federal Republic of Germany for the construction of guided missiles. British Aerospace may become associated with the whole group.

Panavia is another multinational grouping with MBB and British Aerospace as well as Aeritalia participating and which France considers joining. This group builds the fighter plance "Tornado" and will most probably develop a combat plane for the 90s'.

A recent development is the merging of the two German firms Kraus–Maffei and Rheinmetall with the American Food Machinery Corporation – FMC, in order to build a multi-purpose fire support combat vehicle for export. This will be the first time that a US firm has engaged with Europe in a common construction project of an armoured vehicle.

☐ *Licences, Parts Production and Compensation Agreements*

Licences, parts production and assembly work by armament firms of the importing country are well known features of large export deals. They lead to all kinds of co-production arrangements which increase international ramifications.

Another interesting aspect of international armament deals are compensation agreements providing job compensation for the importing country. Arrangements are that a government negotiates the import of expensive equipment, such as fighter planes, on the terms that the exporting country offers in exchange a certain amount of work on products, which can be non-military. Such a compensation agreement was concluded between Switzerland and USA regarding the import of the American fighter plane "Tiger". Besides the assembly work to be carried out in Switzerland, certain American firms will make special orders for mechanical and electronic products from Switzerland so as to compensate work content of the imported planes. This can even help in the importing country to develop diversification into non-military fields.

☐ *Transfer of Armament Production*

Multinational companies engaged in armament equipment take advantage of possibilities to transfer their production across borders. Such practices are revealed about the Swiss armament multinational, Oerlikon—Bührle. It transferred in recent years at least 1,000 jobs for armament from Switzerland to Italy. Bührle subsidiaries in Milan, Rome, Stockach (the Federal Republic of Germany) and Grantham (Great Britain) have all expanded activities for exports due to shifts in armament production. Another Swiss armament factory, SIG, has also transferred work to the Federal Republic of Germany and France.

Such investments in armament production abroad are not simply a shift of workplaces but also deters management from initiating projects for expansion of alternative production at home which would offer much better employment prospects.

V BARGAINING, LABOUR AND SOCIAL CONDITIONS IN THE ARMAMENT INDUSTRY

☐ *Certain Difficulties for Union Activities*

The IMF enquiry on problems faced by affiliates in the armament industry leads to the conclusion that in most countries there are no basic differences regarding union strength and bargaining position between military related production and any other. However, an important handicap is indicated by British affiliates, which no doubt also applies to other countries. They point to the Official Secrets Act which applies to the armament industry and makes the access to certain information impossible. Full use of economic and financial arguments in bargaining is thus impeded.

It is stated that in France, trade unions face great difficulties in this industry sector due to the special position this Government gives to armament in the national interest. This brings about infringements on union rights. French unions particularly mention stringent control over workers involved in armament production extending to their political views, prohibition of access to certain workshops, rigid regulations and strict hierarchy, management refusal to communicate information to work councils and unions and close vigilance by army related bodies.

☐ *Employment Security a Special Issue*

Armament production requires a high level of skill; involving large-scale research and development work as well as high precision in manufacturing. Wages and working conditions following a more general pattern reflect some of these high requirements.

Employment in armament and general military related industries depends on government defence contracts and export orders. It is in the hands of governments, therefore, to pursue a policy of military procurement contracts with the industry that will safeguard employment. Whilst there are positive effects of such a policy – which can even help in situations where civilian orders of related goods are lacking due to recession – major political events, such as the end of the Vietnam War and the sudden cancellation of a certain type of military equipment, can bring about large-scale dismissals.

VI CONVERSION TO CIVILIAN WORK

☐ *The Need for Bold Action*

Successful action to secure employment in the armament industry whilst following a policy aimed at restricting armament production to a minimum, requires concrete measures for the conversion of this sector to civilian activities.

So far projects of alternative production have remained largely insufficient. Some private enterprises have been diversifying their product lines, for instance in the USA, to lessen their dependence on government military contracts and others have attempted conversion to civilian product lines, i.e. mass transit equipment. Many attempts have failed because of inexperience of the producers in the areas they have tried to enter. Initiatives in the legislative field for bolder action have not yet reached the stage of a US Congress vote.

☐ *Union Initiative at Plant Level*

The British Labour Party substantially contributed to the armament and conversion debate with a thorough study "Sense About Defence". This paper seriously considers the feasibility of converting the armament industry to the production of socially useful goods.

Practical proposals for alternative production have been put forward by Lucas Aerospace workers. Lucas Aerospace employs some 13,000 highly skilled design and manual staff in Great Britain. Although its production range is wide, a large part of its business is connected with military aircraft projects, including the Multi-Role Combat Aircraft "Tornado" (MRCA). The Lucas Shopstewards Combine Committee, faced with a permanent threat of redundancies, decided to work out a plan securing their members' employment by producing socially useful goods. The result was a series of concrete proposals — 150 designs for alternative products, all involving adaptation of existing design technology and experience — proving that aerospace technology can be adapted and applied in many fields such as medical equipment, housing with use of low energy, safer transport systems, etc.

These creative proposals from Lucas workers deal with both job security and satisfaction of social needs through conversion. Wide publicity and recognition of their value pressured the Company to abstain from contemplated redundancies although, through natural attrition, 1,000 jobs were lost. As management reaffirms to keep to its established business strategy, only government initiatives will finally enable the application of the alternative job creating proposals.

☐ *Job Loss through Armament Spending*

A significant study has been undertaken by the International Association of Machinists and Aerospace Workers (IAM), about the employment situation for their members and military expenditure. The answer to the question, whether union members in this industry gain or lose jobs if the military budget rises, is crucial for the pursuance of alternative employment programmes.

The IAM report states: "As the military budget goes up, and procurement contracts rise, Machinists jobs in military industry steadily decline. In October 1978, 85,000 IAM members were employed on military contracts either industrial or governmental. In 1975, that figure was 12,300 jobs higher. The drop can be seen clearly in defence dependant states like California and Washington. Much of this job loss can be attributed to technological development. As military industries become increasingly capital intensive, jobs decline. A finding of even greater significance is that in 30 states, many of them recipients of major military contracts, IAM members suffer a net loss of job opportunities when military spending is high. This is because the number of IAM jobs foregone in civilian goods and services because of tax monies going to military exceeds the number of jobs generated by military contracts. A Pentagon budget of $ 124 billion costs the Machinists over 120,000 civilian jobs. When the 85,000 jobs generated by this level of military spending are subtracted, the net job loss to the union is over 35,000 jobs a year."

A similar conclusion arises from international comparisons showing that high shares of military expenditure are often coupled with higher than average unemployment rates. This is characteristic for Great Britain and the USA. Japan and the Federal Republic of Germany with a lower degree of military spending than most nations have considerably lower unemployment.

☐ *Cut in Arms Spending, an Untapped Opportunity for Growth*

The absurdity of military expenditure in face of the urgent need for job creation through economic infrastructure and social development projects is particularly striking in the case of developed countries. If only half of the $ 17,400 million armament deliveries were made, the remaining sum would almost equal the multi-lateral annual development aid provided by OECD countries.

This sum if used for the supply of investment goods to the developing countries would create in Germany alone, based on its expected export share, tens of thousands additional jobs.

Particularly in the case of developing countries armament prevents the use of capital for other investments so that any reduction in military expenditure would provide the greatly needed resources for machines and other job creating equipment. Many developing countries which burden their state budget with armament purchases can hardly carry out basic industrialization as the scarce capital for development investments is missing.

The stop to the armament race, reduction in military spending and arms control must be combined with the launching of worldwide conversion programmes for job creation. Such development projects can concentrate on those in greatest need and be beneficial to all nations. (*Programmes for alternative use of military spending, see Chart VII*)

VII TRADE UNION POSITION ON DISARMAMENT

☐ *Affiliates' Main Line of Policy*

The position of IMF affiliates concerning disarmament and employment problems in the armament industry can be summarized as follows:

IMF affiliates in their Congress Resolutions and other policy statements call for "universal, simultaneous, balanced, controlled and negotiated disarmament".

The two French affiliates, in particular, reaffirm this union attitude by condemnation of arms trade under whatever motives.

A union such as IG Metall in the Federal Republic of Germany "commits itself, on the one hand, to stand up against all action which could increase tensions in any part of the world, and on the other, to support, in the framework of a consistent détente policy, all efforts which aim at diminishing armament expenditure". This implies an armament export ban to countries violating elementary human rights.

In this connection an appeal is made to "all responsible statemen and politicians as well as democratic organizations and forces in all countries, to unceasingly struggle for:

- a reduction of armament and arms budgets,
- a mutually controlled reduction of armed forces, as well as,
- the conclusion of further international agreements concerning the prohibition and distribution of nuclear weapons, bacteriological and chemical warfare agents".

Military interventions have to be replaced by reasonable political solutions for conflicts on the basis of the right of the peoples' self-determination. Measures must be elaborated for the peaceful settlement of conflicts.

A British affiliate indicates "as a first priority the defence of jobs and contracts, then to work towards alternative uses of defence technology for civilian purposes".

☐ *Positions on the Limitations of Arms Exports*

Stressing the "negative union attitudes towards the expansion of arms exports it is stated that such increased exports indirectly endanger jobs in civilian exporting activities".

Political and moral motives are considered so important that export limitations should also extend to international cooperation arrangements for arms production. In the Federal Republic of Germany a recent change in the armament control law submits arms production by German firms in foreign subsidiaries and in the framework of cooperation agreements to strict authorization by the government.

The claim for limitation and cut-back of armament, international arms trade and so-called military development aid is combined with a demand for the elaboration of plans for the change of arms production to civilian needs.

In no way should existing limitations on arms exports be slackened, although everything possible is to be done to reduce to a minimum the threat to workplaces in arms producing undertakings. Short-term problems arising from armament demands should not be solved in a way which will create long-term disadvantages to the workers.

☐ *Job Protection Policies*

IMF affiliates energetically urge for an expansion of civilian production by firms producing military equipment. They emphasize that a worldwide détente policy will liberate resources for other important public demands in fields requiring highly developed technology for production of the environment, communication improvements, etc.

IMF unions, for the protection of workplaces in the defence industry, demand:

- long-term capacity planning for research and development as well as production,
- use of all kinds of public measures for maintaining and expanding the proportion of civilian production in establishments producing defence equipment,
- avoidance of an expansion or shift in capacities through new armament orders which would increase the dependency on future arms orders,
- right of union representatives at the various levels of defence production to both vigorously and regularly insist on policies for a continuous follow-up of efficient non-military production and timely action for the necessary development work.

Practical and effective measures in these fields are indispensable for implementing the United Nations policy, emphasized by the Conference on Security and Cooperation in Europe (CSCE), for a worldwide abandonment of new armament objectives and the reduction of armament expenditure by 10 per cent in order to use then available resources for the creation of work and social expenditure in the interest of the working population.

Such an approach requires internationally controlled disarmament to be carried out through efficient national armament controls, including all economic and social measures.

In the framework of the above objectives, IG Metall, the Federal Republic of Germany, created a discussion group on armament technology and employment, directly responsible to the unions' Executive Committee. This discussion group will not deal exclusively with the situation of workers in armament undertakings and their defence, but will also, on the basis of union decisions, explore possibilities for the safeguard of all workers concerned by temporary or permanent reduction of armament expenditure. A main objective is to ensure a sufficient, constant flow of orders, as far as possible, in the civilian field to avoid situations where the justified defence of armament workers jobs may handicap the pursuance of initiatives for disarmament and peace.

☐ *Common IMF Position*

The unanimously agreed IMF policy on disarmament and worldwide peace enounces the following main principles stated in the Resolution by the Congress in Munich, 1977:

- "The international trade union movement has always fought for détente, disarmament and maintenance of peace and considered that an understanding among states even with differing ideologies is a necessary pre-requisite for peace;

- IMF deplores the continued armaments race and the persistent international arms trade;

- demands prompt and effective continuation of negotiations on controlled international disarmament and a prohibition of arms exports into territories where crises exist;

- demands also that the production, use and supply to other countries of nuclear weapons be prohibited. Trade agreements on the supply of nuclear power stations must ensure through effective clauses on control that no misuse can occur for military purposes;

- confirms its conviction that peace can be best achieved through the elimination of poverty, inequality, ignorance and exploitation in the world."

METALWORKERS UNIONS AND THE ARMAMENT INDUSTRY

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ECONOMIC ASPECTS

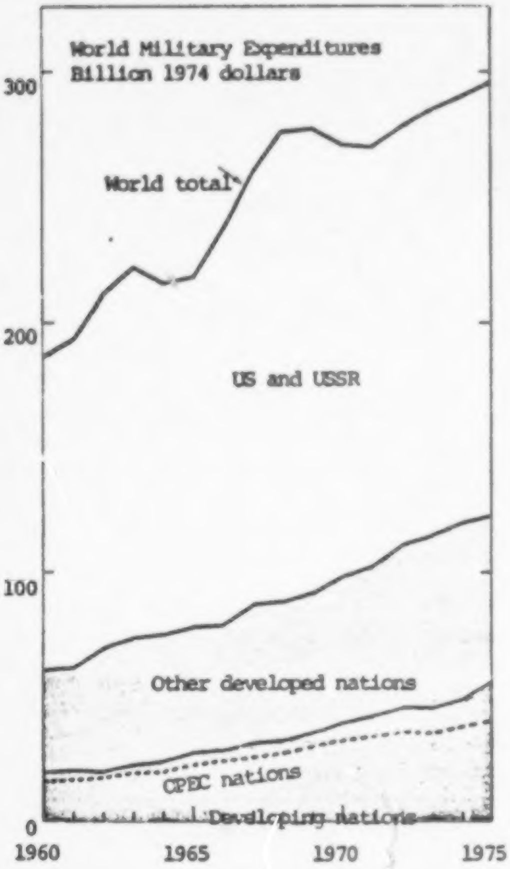
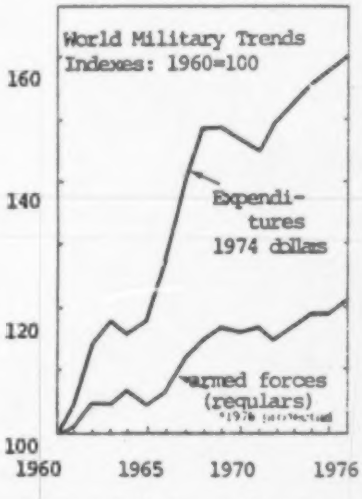


Chart I

Chart II



Source: "World Military and Social Expenditure 1977" - Ruth Leger Sivard

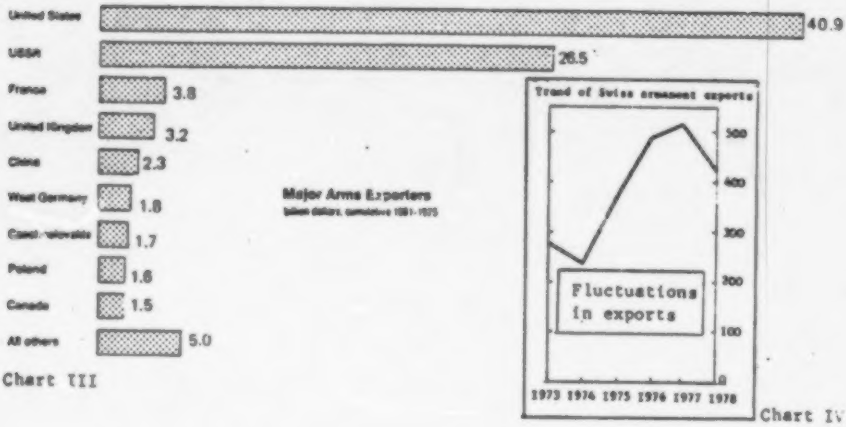
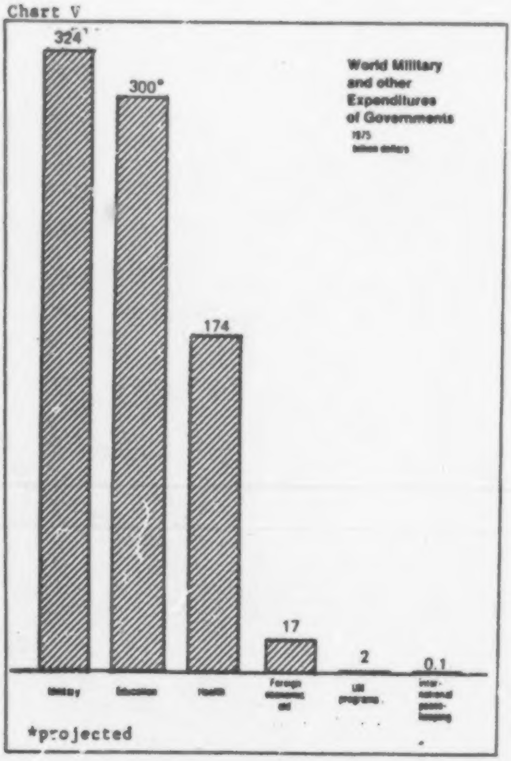


Chart III

Chart IV

Chart V

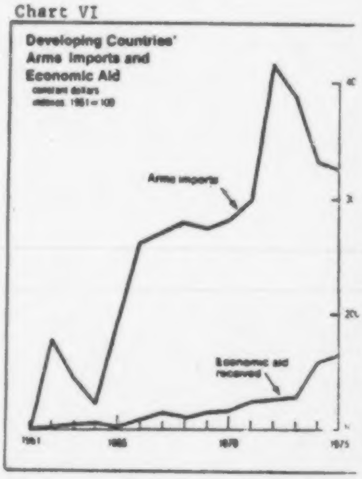


*projected

SOCIAL

ASPECTS

Chart VI



Source : "World Military and Social Expenditure 1977"-Ruth Leger Sivard

5% LESS IN MILITARY SPENDING WOULD ACHIEVE :

Chart VII

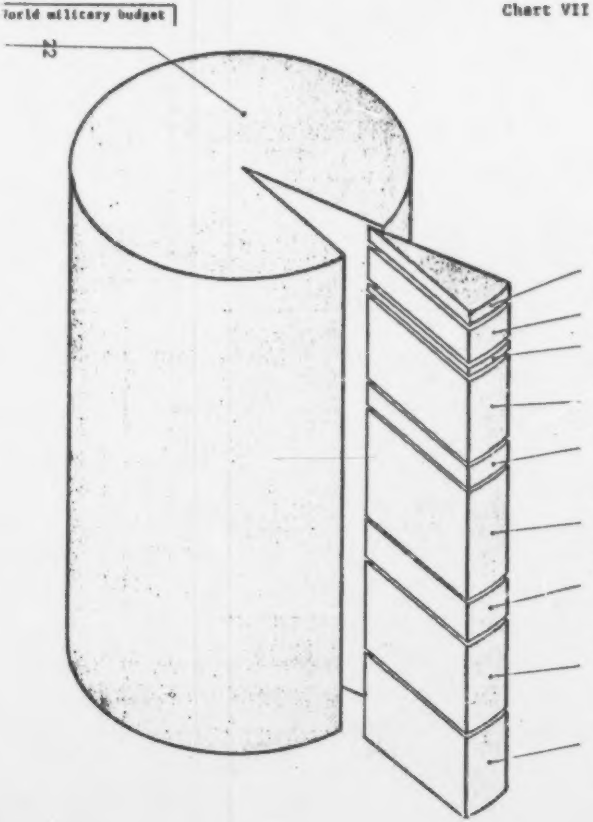
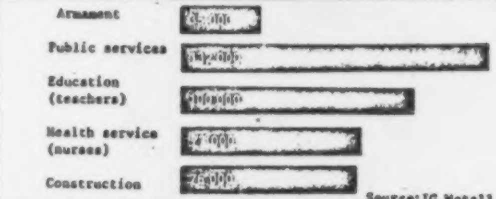


Chart VIII

Number of jobs created by $ 1000 million State expenditure if channelled to the various activities



Source: IG Metall

$600 Mio : a vaccination program to give protection against infectious diseases to all infants

$1200 Mio : program to extend literacy to all adults by the end of the century

$250 Mio : : a preventive and community-oriented training program for a sharp increase in the numbers of medical auxiliaries

$3000 Mio : increased development aid to improve the capacity of the Third World to grow its own food, and prevent malnutrition

$750 Mio : an expanded minimum-shelter program, incorporating self-help construction, for the urban poor

$4000 Mio : supplementary feeding to ensure full development for 200 million malnourished children

$1500 Mio : supplementary feeding for 60 million malnourished pregnant and lactating women to protect their health and reduce infant mortality

$3200 Mio : major increase in the number of primary schools, with the addition of 100 million new places

$3000 Mio : hygienic water supplysystems, toward the goal of clean water for all humanity by 1990

Source: "World Military and Social Expenditures" -Ruth Leger Sivard

TABLE IX

ANNUAL PRODUCTION VALUE OF MILITARY PRODUCTS AND PROPORTION OF MILITARY PRODUCTION IN RELATION TO TOTAL PRODUCTION

a: production value in Mio. $

b: proportion of military production in relation to total production

(Source : IMF)

Country	Period	Field:	General weapons	Aerospace	Ship-building	Electronics[1]	Total	Explanations
Belgium	1977	a	322	..	–	..	..	
		b	–	..	–	..	..	deliveries
Canada	1976	a	..	..	..	..	292	defence production
		b	–	..	..	..	7.3	
Germany	1976	a	1986–2384	..	..	..	..	
		b	–	60	20	..	..	
Great Britain		a	4687	2222	495*	..	..	*average figures for the last three years
		b		65.6	21.1*	..	..	
Great Britain		a	..	3607	3108	2442	..	
		b	–	..	..	..	..	
Italy	1978	a	..	..	..	..	2354	
Japan	1976	a	312	647	60	161	1180	
		b	–	50.1	4.6	12.5		
Nether-lands	∅ 1970–1975	a	34	48	52	111	245	
		b	–	25	10	33	..	sales
Norway		a	30	..	31	..	..	sales for defence = 6% of total sales in the mechanical engineering industry
		b	–	..	..	..	..	
Sweden	1977	a	168	370	112	..	..	
Switzerland	1977	a	–	..	–	..	214	
		b	–	..	–	..	..	exports
U S A		a	3800*	1870*	5200**	8400**	..	
		b	–	55*	60 *	20**	..	*1977 ** 1976

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1) The share of military orders in the electronic parts field reaches an average of 7% of the European market

TABLE X

PROPORTION OF MILITARY AND ARMAMENT EXPENDITURE IN RELATION TO GPOSS NATIONAL PRODUCT

Country	Military expenditure %			Armament Expenditure in relation to GNP
	1974	more recent:	year	
Austria	0.9	1.2 1)	1978	
Belgium	2.8	2.6 1)	1977	
Canada	2.0	0.6 2)	1978	
Denmark	2.4	..		
France	3.6	..		
Germany F.R.	3.6			1976 0.6% (8100 Mio DM in 1979)
Great Britain	5.2	..		
Israel	35-40	35-40		
Japan	0.8	0.9		0.35% of GNP in 1978/79 (676 000 Mio yen)
Netherlands	3.4	4.0	since1965	
Norway	3.1	8.0 3)	1977	
Sweden	3.1	3.3	1977	
Switzerland	1.9	3.0	1977	
USA	6.2	5.2	1976	
USSR	..	12.0	1976	

1) defence budget
2) 0.3% for capital expenditures
3) incl. wages, development costs, services and products purchase and civil defence expenditures

Source : "Sense about defence"-The Report of the Labour Party Defence Study Group-Great Britain 1977- for 1974
IMF for more recent

TABLE XI

EMPLOYMENT IN ARMAMENT FIELDS

(Source: IMF

Country	Field: Period	General weapons	Aerospace	Ship-building	Electronics	Total	Explanations
Brazil		4 000					
Canada	1976					9 700	
France						270 000	= 10% of employment in the metal industry of which 130 000 in private enterprises
Germany	1976	150 000	30 000	14 000	6 000 **	200 000*	* of which 6 000 to 8 000 depend on armament exports **estimate
Great Britain		200 000	120 000	160 000	145 000	625 000	
Italy	1978	..	..	..	..	90 000	
Japan		..	12 500	11 600	4 000	35 000	estimated employment figures based on the share of military production in total output of the respective sectors
Netherlands		..	(2 000)	(2 100)	(4 700)	25 000	() persons directly employed
Sweden						25 000	
Switzerland		15 000				20 000	of which 5 600 depended on armament exports, i.e. 1% of total industrial employment
U S A		156 000	449 500	156 700	387 200	1 149 400	

RESTRICTIONS ON EXPORTS INTO CRISIS AREAS

(Source : IMF)

Country	Yes	No	
Austria	x		Any armament export deal has to be authorized by the Government and is only possible if a special commission surveying the countries' neutrality approves
Belgium		x	
Canada			
France		x	Apart from the embargo period decided by de Gaulle on 3 June 1967 concerning mirage planes bought by Israel, France sells arms to countries without distinction, including countries in conflict
Germany	x		According to a cabinet decision by the German Government armament goods can, in principle, only be exported to NATO member countries, as well as to Australia, New Zealand, Sweden and Switzerland
Great Britain	x		
Israel			
Japan	x		
Netherlands	x		With regard to Rhodesia and South Africa limitation of arm exports is carried out in compliance with United Nations decisions. In addition there is a selective policy of restricting exports of arms in cases where the supply would increase the risk of conflict in crisis areas
Norway	x		
Sweden	x		
Switzerland	x		A special law on armament equipment restricts exports particularly to regions with a threat of conflict. Further stringent interventions can be based on the federal constitution which states the Governments competence for preserving the interests of the State in its outside relations as well as the independency and neutrality of Switzerland
U S A	x		

UPDATED FACTS AND DEVELOPMENTS
ON THE
"METALWORKERS' UNIONS AND THE ARMAMENT INDUSTRY"

September 1979

UPDATED FACTS AND DEVELOPMENTS
ON THE
"METALWORKERS' UNIONS AND THE ARMAMENT INDUSTRY"

I IMPACT OF ARMAMENTS PRODUCTION ON WORKERS AND THEIR FAMILIES

Negotiations for a SALT II agreement were the main feature of recent developments. The following considerations on the impact of SALT II have been brought forward in the United States, partner to the proposed agreement :

Defense industries are so expensive to run that it takes about $1000 million to create about 45,800 jobs, whereas the same investment leads to from 59,000 to 88,000 jobs if spent in the civilian sector. It is estimated that SALT II will cut the amount the USA needs to spend on arms and will release between $30,000 to $60,000 million of public funds. This means that the savings gained by the ratification of the SALT II agreement could result in the creation of nearly 1.8 million jobs.

In past years more and more people have become aware that military spending does not create as many jobs as was thought previously. Defense industries have become so automated that it takes fewer workers to run a defense plant than to operate factories producing goods for civilian consumption.

In this regard it is interesting to note that the programme for the production of new MX missiles — which, at present cost estimates, would absorb about 30–70,000 million dollars — will create a meagre 38,000 jobs over the next 8 years, half of those jobs being for engineering and professional ranks.

Right now, the USA and USSR are capable of delivering a combined total of 14,000 million tons of nuclear explosives, i.e. 3 tons for every man, woman and child in the world. Maintaining this ridiculous and dangerous over-kill capacity represents a cost of $2,350 for every American household, which could be much more wisely spent for the benefit of families, the poor and the weak.

II THE SIGNIFICANCE OF SALT II

☐ *An Important Step*

The signature of the second Strategic Arms Limitation Treaty, commonly referred to as SALT II, will primarily limit the growth of nuclear weaponry in the Soviet Union and the United States and thus lower the risk of nuclear war.

Ratification by the United States Senate of SALT II could represent a small, but important, step in a process which will help achieve real national security in the longer run as the USA and USSR undertake further SALT III negotiations. Rejection of the Treaty would mean an unrestrained arms race and increased risks of nuclear annihilation.

SALT I dealt with defensive weapons, whereas SALT II is aimed at limiting some offensive arms. SALT I also established methods for each side to monitor the other's weapons development, methods which are expanded during SALT II. The Standing Consultative Committee (SCC), a special forum set up for the USA and USSR to resolve all questions linked with SALT I, has, according to experts, proven effective. It would continue to function as an enforcement body under SALT II.

Detailed reports by the U.S. State Department and by American scientific experts confirm that the USA has the technological know-how to make sure that the Soviet Union abides by its commitment.

SALT II requires the Soviet Union to scrap about 270 of its nuclear missile launchers, because the allowed number is inferior to its present possessions. The SALT II treaty also sets equal limits on the number of intercontinental missiles and bombers that could be deployed by the USA and the USSR, and sets equal ceilings on the number of warheads that can be placed on each country's missiles.

However the SALT II agreement does not consider the development of conventional (traditional) weapons such as tactical aircraft, cruisers, destroyers, tanks, etc. It allows the US to launch the MX — missile experimental — system programme. According to the Pentagon, the cost of production and deployment of 200 MX missiles stands around $30,000 to 50,000 million; experts agree that by the time of deployment in 1986 the bill will be inflated to $70,000 million.

Although in many respects unsatisfactory, the SALT treaties and particularly SALT II slow the arms race. Valuable resources and skills could now be diverted from the building-up of additional over-kill capacity to investments in civilian industries.

☐ *Backing by IMF American Affiliates*

In the battle around the treaty, all main American trade unions have pledged support in the effort aiming at ratification by the U.S. Senate.

The UAW has made clear its position in a series of statements throughout 1979 and considers the treaty as part of a continuing process. "If ratified, the limits it establishes now can be enlarged during SALT II and negotiations thereafter. While SALT II will not prohibit further arms production, it will limit production and development from what might otherwise haven taken place".

The International Executive Board of the United Steelworkers of America issued a statement on May 4 this year endorsing the SALT II treaty. The declaration was made after the Board was briefed on the negotiations by Vice President Mondale and Dr. Zbigniew Brzezinski. The USWA believes that "Such a strategic arms limitation treaty between the two most powerful nations in the world will be in the best interest of world peace, will be another vital step in bringing nuclear weapons under control and will avoid a dangerous and costly nuclear arms race". It felt confident "that our national security will not be endangered and that we will be able to adequately monitor compliance by the Soviet Union".

Another main American IMF affiliate, IAM, took an earnest stand in favour of SALT II. It urges "each man and every IAM member to follow the SALT II debate carefully and write to U.S. Senators urging them to vote to ratify the Treaty". The IAM Executive recognizes the need for a strong national defense, while "wasteful military overspending can be as injurious to the nation's long term welfare and security as spending too little".

III TOWARDS A COORDINATED EUROPEAN DEFENSE APPROACH

In the pursuance of an effective defense of democratic countries, NATO can play an important role that will favour efforts towards détente, the control of the armaments race and the reduction in armaments. There can be a reduction of the heavy load of defense costs by closer cooperation, particularly in the armaments industries. This could also contribute to common restraint of arms exports.

Two of the fundamental objectives of the North Atlantic Treaty Organization – NATO – suffer from chronic drawbacks: one is the standardization and interoperability of armaments and the other one is the establishment of a two-way street between North America and Europe, in order to create a better equilibrium.

It is in the field of armaments purchase and manufacturing that the lack of an European integrated programme is more evident and disadvantages more striking, particularly as far as the Soviet bloc and the industrial and financial power of the United States are concerned.

For example, in the European Community alone 19 aeronautics firms compete whereas in the United States only 8 companies share a far greater turnover. This represents great waste of resources, lower efficiency and hardly any economies of scale. Overlapping in armaments – particularly in research and development – in the NATO region is estimated to cost around $10,000 million per year. Therefore the need for interoperability is widely recognized whereas standardization remains an objective for the more distant future.

In recent years, both sides of the Atlantic have become highly aware of these problems. NATO has recognized the need "to maintain in Europe a very developed European industrial, technological and scientific basis while pursuing the closest possible cooperation between North America and Europe in purchasing and producing armaments".

Besides the Western European Union, which is a forum where European parliamentarians discuss defense, several organizations exist for European cooperation in the field of armament: the Eurogroup, the Independent European Programme Group (IPG) and the Conference of National Armament Directors of the NATO.

The Eurogroup brings together the European member countries of NATO. The IPG gathers the member countries of the Eurogroup plus France and has led to the elaboration of a European armament policy independent of the NATO military structure. A certain harmonization of needs can also be drawn up. The Conference of National Armament Directors (CNAD), which is under the authority of the NATO Council, aims at promoting cooperation among the various countries producing armaments.

The big defense industry has created a special organ, the European Defense Industries Group (EDIG), aiming at the establishment of contacts with the IPG. The objectives of the EDIG are the following: react to the IPG proposals in the industrial fields; set up industrial cooperation agreements to put into practice the IPG programmes and closely cooperate in order to improve the use of technical and financial resources.

The recent developments and the setting up of ad hoc international groupings will bring about changes in the structure of the big armament industry. This will affect employment development in main producing nations, particularly in times when research, development and production costs are soaring.

Metalworkers' unions must be able to control the implications of such structural changes. As production capacities in the armaments industry will be shifted between countries, measures must be taken to prevent a scramble for orders to keep in operation capacity which would otherwise be idle. This necessitates timely measures with union involvement, to guarantee employment through long-term planning of production changes and reconversion.

IV JOB CREATING EFFECT OF CIVILIAN VERSUS MILITARY PRODUCTION

One of the most persistent myths of modern times is that military spending is good for the economy. People believe that it was not the war that ended the depression but the enormous sums spent by the American Federal Government on hiring soldiers and on buying war materials. Sums of this magnitude spent on anything would have ended the depression. "We could have rebuilt the railroad system, upgraded our supply of housing, and built desperately needed new schools and hospitals. Any large capital outlays which put millions of people to work would have had the same effect on the economy", says a report by the US Coalition for a New Foreign and Military Policy.

An analysis was undertaken by Professor Bruce Russet of Yale University in order to show where Americans would spend their money that goes through taxes to the Pentagon. A calculation based on established preferences indicated how much money and thus how many jobs the military budget takes from each sector of the economy. Combining the number of jobs generated and lost through military contracts, an employment balance for each state can be drawn. The result is striking: 60 per cent of the American people live in states which *lose* jobs every time the military budget goes up.

Every major industrial state in the country, except Texas and California, loses more jobs than it gains. The Mid-Atlantic states lose 573,000 jobs. The Industrial Midwest loses 572,000 jobs. While the South and Southwest gain, the nationwide employment impact is a net loss of 907,000 jobs.

Yet, for every thousand million dollars transferred from military industry to civilian industry 14,000 more jobs would be created. If a thousand million dollars were used by state and local governments to hire teachers, police and firemen, 30,000 more jobs would be created.

In a booklet entitled "Prosperity Without Guns", Betty G. Lall of the New York School of Industrial and Labour Relations explains that reductions in military expenditures need not have negative economic effects if properly planned in advance. Since economic changes, resulting from arms control or disarmament, cannot occur overnight, the transfer time could be used to prepare for the expected changes. Plans are needed to arouse business, labour, government and communities to contract cutbacks so that the temporary hardships for the most vulnerable can be mitigated.

The UAW has offered a plan for converting plants to non-military work. The UAW plan proposes to place part of a defense contractor's profits in a trust fund to be used to convert companies to civilian production. Some of these funds would also be used to pay the wages of workers who have been laid off. Advance notice to workers by the company, company action taken to help place laid-off-workers in jobs elsewhere are all factors which help. As many defense workers are recruited nationally, they are more willing than people recruited locally to move to new areas.

V EFFORTS TO CONTROL ARMAMENTS EXPORTS

☐ *Union Position expressing the Concern of Workers in Armament Plants*

Since this report was first published, IG Metall's discussion group on "Armament Technology and Employment" met a second time in June this year. This discussion group brings together the Works Councils of the most important armament companies. The group opposed the constant redefinition of conflict zones for which licences for exporting armaments are in principle forbidden. Exports through the redefinition of conflict zones cannot be the proper way of securing employment. A stop must, in any case, be put to the expansion of production capacity in armament industries.

At the same time the group considered it indispensable to make jobs secure in production fields absolutely needed under present defense requirements.

On the other hand reports from the shop floor show clearly that disproportionate spreading of defense orders by military authorities repeatedly cause setbacks to employment in individual companies.

The discussion group of IG Metall energetically demands that such fluctuations in employment be prevented through long-term policy guaranteeing equilibirum between employment and capacity by an adequate redistribution of orders.

To this end the works council representatives request long-term planning for the whole armament industry.

☐ *Initiatives for Control of Arms Exports*

Italian metalworkers feel more and more uneasy about being involuntarily producers of death and repression instruments and at the same time being involved in dramatic problems linked with the economic crisis and high unemployment.

FLM calls for a parliamentary initiative to establish parliamentary control. This should make the control of arms exports more effective and bring about the prohibition of sales to conflict zones or countries with racist and fascist regimes. It must be realised in this connection that international endeavours to restrict arms exports can offer any prospect of success only if all leading armament producing countries, both East and West, join in wholeheartedly.

Moreover, Italian trade unions request political parties to approve the sector plan for the crisis-stricken shipbuilding industry, so as to secure work for the shipyards at present strongly dependent on expensive military contracts which are no permanent solution for employment problems.

Other political initiatives are launched in the civilian aeronautics field in order to secure and develop employment, particularly in Southern Italy, which military contracts cannot do. The FLM favours participation in European aeronautics projects and programmes which will enable the Italian civilian aerospace industry to share in all the stages of European development in that industry.

VI BASIC TRADE UNION POLICY

Forty years after the tragic outbreak of the Second World War, IMF President Eugen Loderer stated the trade union position on the need for disarmament as follows:

- The maintenance of peace is a prerequisite for voluntary equality of political and social rights and has absolute priority.
- The trade union fight for peace, détente and disarmament has always been and will always remain the corner-stone of a progressive policy for a just and humane society.
- Action against the accelerating armaments race in all parts of the world is therefore no less vital than in previous decades.
- The workers' interest in safe jobs can in no way impede the endeavours for the relaxation of tension or be misused to boost armament expenditure.
- Any success of previous détente and disarmament conferences was not convincing or lasting. That is why trade unions must bring the utmost pressure to bear on all parties striving for peace to make real progress. □

Senator **Weicker**. Thank you very much, Mr. Winpisinger.

Mr. **Winpisinger**. Thank you, sir. I appreciate the opportunity. I wish you Godspeed in your deliberations. It is not an easy one.

Senator **Hayakawa**. Let me thank you also.

[The prepared statement of Mr. Winpisinger follows:]

PREPARED STATEMENT

OF

WILLIAM W. WINPISINGER, INTERNATIONAL PRESIDENT

INTERNATIONAL ASSOCIATION OF MACHINISTS
AND AEROSPACE WORKERS

"INTEREST RATES AND SMALL BUSINESS"

COMMITTEE ON SMALL BUSINESS

U.S. SENATE

WASHINGTON, D.C.

SEPTEMBER 24, 1981

Mr. Chairman:

Members of the Committee:

On behalf of the men and women represented by the International Association of Machinists and Aerospace Workers, we appreciate your invitation to testify on interest rate inflation.

Our members work in plants and shops, both large and small, that cut across 13 major industrial sectors of the U.S. economy. Our skills range from those of highly skilled electronics and aerospace technicians, machine shop tool and die makers, and heavy equipment, auto and air transport mechanics to those in the semiskilled and unskilled job classifications. We have members working in both the private and public sectors of employment.

We believe our experience in the real world of work gives us economic insights that are not visible to the architects of the Reagan Administration's current economic quandary, which is distinguished only by the poverty of its theory.

Two minus two plus four simply doesn't equal one hundred. That kind of math simply won't deliver America to the land of milk and honey. The Capital Strike on Wall Street confirms that.

You've invited the Machinists to comment on the cause of and solutions to high interest rates - in 10 minutes or less. And time is tolling.

Very simply, interest rates are high because that is the official policy of the government. Change the policy and interest rates will come down.

As devoted to the free market as supply-siders and monetarists are, neither side can say what the true market price of loanable funds - the interest rate - is. All they can say is that they are artificially high, but they've set them there in violation of their own noninterventionist creed to get back to a pristine market system.

Given the concentration of wealth and capital in the U.S., it isn't surprising that interest rates aren't doing what they're supposed to do. A handful of hugh bank and financial institutions dominate the money markets. They own and control the bulk of loanable funds in the private sector and they work together to fix the price for government securities in the public sector. That, in turn, increases the cost of government debt servicing - the interest on the debt - and hence, increases the debt itself.

A balanced budget, Mr. Chairman, or reduction of the federal deficit is not in the best interests of those few powerful financial institutions. And elimination of the federal debt would bankrupt them. So the monopolistic behavior of those few financial firms is part of the cause of high interest rates.

SUPPLY-SIDERS AND MONETARISTS SIMPLY DO NOT RECOGNIZE THE STRUCTURE OR THE CONCENTRATION OF CAPITAL AND WEALTH. THEY KEEP ENVISIONING THOUSANDS OF SMALL HOMETOWN BANKS OUT THERE IN SOME PASTORAL AND MYSTICAL FREE MARKET PLACE. THAT VISION DOESN'T SQUARE WITH EMPIRICAL EVIDENCE.

AT THIS POINT, MR. CHAIRMAN, I RESPECTFULLY REQUEST THAT A RELEVANT PORTION OF A SENATE COMMITTEE ON GOVERNMENT AFFAIRS STAFF STUDY CONCERNING THE STRUCTURE OF CORPORATE CONCENTRATION IN MONEY AND BANKING BE INCLUDED IN THE RECORD TO SUBSTANTIATE OUR ASSERTIONS. THE STUDY IS IN THE FORM OF A COMMITTEE PRINT ISSUED DURING THE 96TH CONGRESS 2ND SESSION.

THE ADMINISTRATION'S THEORY OF THROWING MONEY AT BIG MONEY WON'T INDUCE PRODUCTIVE INVESTMENT. IT WON'T CREATE THE MULTIPLIER AND RIPPLE EFFECTS NECESSARY FOR ECONIMIC GROWTH. THE INVESTORS WHO COUNT RESIDE AT THE TOP OF THE ECONOMIC PYRAMID. WHY WOULD THEY PUT THEIR MONEY OR LEND THEIR MONEY IN A LONG-TERM STEEL MILL MODERNIZATION PROGRAM THAT WILL PAY 12 OR 15% OR LOAN MONEY TO A MARGINALLY PROFITABLE SMALL BUSINESSMAN, WHEN THEY CAN BUY A GOVERNMENT SECURITY THAT WILL GUARANTEE 16 OR 17%; OR THEY CAN BUY SHORT TERM CORPORATE COMMERICIAL PAPER THAT WILL PAY 20% OR MORE.

THEY WON'T, AND THAT'S WHY THE INDUSTRIAL BOND MARKET IS BUST.

THE REALLY BIG MONEY IN THIS COUNTRY IS THRIVING ON EXCESSIVE INTEREST RATES. IT IS EASY MONEY AND THOSE HUGE BANKS AND FINANCIAL INSTITUTIONS - NOT TO MENTION THE LESSER FINANCIAL ARMS OF SOME OF OUR MANUFACTURING FIRMS - ARE TAKING FULL ADVANTAGE OF IT. AND THEY HAVE THE CLOUT TO MAKE THE PROGRAM STICK. AS LONG AS THEY PREVAIL, AS LONG AS THEY HOLD THE BULK OF INVESTMENT DECISION MAKING POWERS IN THEIR HANDS, WE WILL CONTINUE TO EXPERIENCE SHORT TERM, SPECULATIVE, NON-PRODUCTIVE INVESTMENT. IN THIS SYSTEM, NO ONE GOES FOR THE HARD-EARNED MONEY, WHEN THERE IS EASY MONEY TO BE MADE.

Even in the manufacturing sector, where a majority of our members work - but many are now unemployed - we can observe the behavior of our largest employers and see another reason why high interests are failing to curb the supply of money. That's what we are told they are supposed to do. They don't, because the big corporations, those among Fortune's Five Hundred, don't have to borrow money from traditional lenders. They have their own enormous retained earnings and cash flows. They can borrow and discount each other's commericial paper. Conglomerates can sell-off marginal units and subsidiaries for cash. Multinational Corporations can borrow from foreign central banks or avail themselves of Eurodollars and Asiadollars. No one in the world actually knows just how large those pools of readily available and loanable dollars are. It is estimated to be in the hundreds of billions. Telecommunications and electronic fund transfers can switch those funds from assets to liabilities and back again at the speed of light.

But the point is, U.S. Federal Reserve policy does not reach any one of those sources of loanable funds. The official interest rate can be 100% here in the U.S., and the really large corporations and businesses won't be deterred one bit from borrowing. As fast as the Fed can contract the money supply and domestic interest rates are raised, the giants can do any number of things and go any number of places to get cash at cheaper rates. And they can use that cash for any purpose - to speculate, to acquire other firms, to pay-off more expensive debt. None of that kind of borrowing activity creates productive jobs or products.

Neither small businesses nor consumers have access to those sources of capital. Federal Reserve policy, then, impacts almost solely on small businesses and consumers. To them, far from being a source of income or wealth, high interest rates mean a high cost of doing business and a high cost of living.

To a limited extent, it might be argued that tax breaks will help small business make up for the high cost of borrowing - that the Reagan Corporate tax cuts for firms with net income of less than $50,000 will, in effect, subsidize high interest rates. Two percent tax cuts simply won't equalize 20 percent interest rates.

Similarly, those paltry tax cuts for individuals earning less than $30,000 a year, simply won't equalize or offset mortgage rates of 13 to 15 percent. The housing industry will remain in the doldrums under those conditions.

We believe this Committee and the Congress must realize that what we are dealing with in the real world, is a dual economy.

We have a super economy comprised of 7 to 8 hundred giant firms who conduct 70% of the nation's business transactions, own or control 88% of the industrial assets, and receive 90 percent of the net profits.

Below them, dogfighting for the remaining 30% of business and 10% of the profits, but employing roughly two-thirds of the private active work force, are the small businesses - some 10 to 11 million of them.

IT HAS LONG BEEN A SOURCE OF AMAZEMENT TO ME THAT SO MANY SMALL BUSINESS LEADERS MAINTAIN A BLIND SENSE OF LOYALTY TO TENETS AND PRINCIPLES WHICH ARE DAILY DOING-IN THEIR CONSTITUENTS. BEYOND RATIONAL DISCOURSE, SMALL BUSINESS ASSOCIATIONS AND ORGANIZATIONS PARROT THE SLOGANS OF THEIR BIG BROTHERS IN THE SUPER-ECONOMY; PEDDLE THEIR THEORIES, SUPPORT THEIR POLICIES, VOTE FOR THEIR CANDIDATES AND CARRY THEIR LOBBYISTS WATER. THEY SEEM TO BELIEVE THE OWNERS AND ENTREPRENEURS THEY PROFESS TO REPRESENT ARE EQUAL PARTNERS WITH THE BIG BROTHERS OF THE BUSINESS ROUNDTABLE, HAVING COMMON AND SHARED BUSINESS INTERESTS.

THEY AREN'T EQUAL PARTNERS, DON'T HAVE EQUAL BUSINESS OPPORTUNITIES OR EQUAL ACCESS TO CAPITAL AND MARKETS.

IF THEY DO NOTHING ELSE, THE REAGAN ADMINISTRATION'S ECONOMIC PROGRAM AND DELIBERATE INTEREST RATE CRUNCH AT LEAST PROVE THE POINT.

WE WOULD ADVISE THE SMALL BUSINESS COMMUNITY TO LOOK WHO IS SUFFERING; SEE WHO IS PROSPERING.

LET US INTERJECT AT THIS POINT. THAT WE DO NOT BELIEVE THE FEDERAL DEFICIT, IN AND OF ITSELF, IS THE PRIMARY CAUSE OF HIGH INTEREST RATES. OUR MAJOR COMPETITORS IN WORLD TRADE HAVE MUCH GREATER DEBT-TO-GROSS NATIONAL PRODUCT RATIOS AND THEY ARE OUTPERFORMING US ON ALMOST ALL ECONOMIC FRONTS.

MILTON FRIEDMAN, HIMSELF, THE MONETARISTS'GURU, ADMITS IN THIS WEEK'S ISSUE OF NEWSWEEK, THAT THE CURRENT DEFICIT IS NOT AS LARGE - AS IT WAS IN PAST YEARS. YET DURING THOSE EARLIER YEARS WITH LARGER DEFICITS, WE HAD 8 PERCENT INTEREST RATES. TODAY WE HAVE SMALLER DEFICITS AS A PERCENT OF GNP AND 20 PERCENT INTEREST RATES. THIS COMMITTEE MAY WANT TO EXAMINE THESE CONTRADICTIONS OF CONVENTIONAL CONSERVATIVE WISDOM.

ASIDE FROM DISCRIMINATORY HIGH INTEREST RATES, THE ADMINISTRATION'S HUGE DEFENSE SPENDING SPREE DISCRIMINATES AGAINST SMALL BUSINESS IN FAVOR OF LARGE PRIME CONTRACTORS AND SUBCONTRACTORS. SET ASIDES FOR SMALL BUSINESSES ARE PALE IN COMPARISON TO THOSE GOING TO PRIMES AND LARGE SUBS. PROFIT MARGINS ARE FAR LOWER; COST-PLUS CONTRACTING MUCH LESS A FACTOR, AND THE WORK MUCH LESS SECURE FOR SMALL BUSINESSES ENGAGED IN MILITARY PRODUCTION. AND THEY HAVE TO COMPETE WITH PRIMES FOR MONEY TO GEAR UP.

DOMESTIC BUDGET CUTS WILL ALSO IMPACT HEAVILY ON SMALL BUSINESSES, SINCE TRANSFER PAYMENTS TO RETIREES, THE UNEMPLOYED FOOD STAMP AND WELFARE RECIPIENTS, FARMERS, SCHOOLS AND MANY OTHERS, ARE ALMOST IMMEDIATELY USED TO PAY FOR PURCHASES FROM SMALL BUSINESSES. CUT TRANSFER PAYMENTS AND SMALL BUSINESSES LOSES BUSINESS.

DEREGULATION, TOO, PROMISES TO HURT SMALL BUSINESS. BANK DEREGULATION PUTS THE SMALL AND MARGINAL BUSINESSMAN IN COMPETITION WITH BIG BUSINESS AND THE GIANTS FOR ACCESS TO CAPITAL. AS LOCAL BANKS AND FINANCE COMPANIES ARE ACQUIRED BY LARGER, OFTEN NATION-WIDE FIRMS, PERSONAL CONCERN FOR THE LOCAL BUSINESS GIVES WAY TO THE NEED FOR BRANCH MANAGERS TO PRUNE THEIR LOANS AND MAXIMIZE PROFITS. / THE SAFEST LOAN IS A BIGGER LOAN TO A BIGGER CUSTOMER. THE $25,000 TO $50,000 INDEPENDENT AUTO DEALER OR AUTO PARTS SUPPLIER IS NO MATCH IN COMPETITION FOR A LOAN TO A GM-BACKED DEALER OR NATIONALLY FRANCHISED SUPPLIER.

ASIDE FROM THE IMPACT ON SMALL BUSINESS BORROWERS, SMALL LENDERS THEMSELVES FACE EXTINCTION DURING THE BANK DEREGULATION PROCESS, WHICH PROMISES TO DRASTICALLY REDUCE THE NUMBER OF FINANCIAL INSTITUTIONS.

OIL AND GAS DEREGULATION HAS ALREADY SHUT THE DOORS OF THOUSANDS OF SMALL BUSINESSES. BUT THE LAST REMAINING PART OF THE REAGAN ECONOMIC PROGRAM IS YET TO COME. THE IMMEDIATE LIFTING OF REMAINING PRICE CONTROLS ON NATURAL GAS PROMISES TO DRIVE THOUSANDS MORE INTO BANKRUPTCY. THOSE THAT AREN'T LITERALLY BANKRUPTED MAY WELL FIND THEMSELVES BORROWING AT HIGH INTEREST RATES TO PAY ENERGY AND UTILITY BILLS.

LOOKED AT REALISTICALLY, NEITHER BANKING NOR NATURAL GAS DEREGULATION PROMISE MUCH FOR SMALL BUSINESSES, EXCEPT THE CONTINUED CREDIT SQUEEZE.

THE SOLUTION TO THE PROBLEM MUST BEGIN WITH RECOGNITION THAT THE U.S. HAS A DUAL ECONOMY. NEITHER A UNIFORM AND BROAD FISCAL POLICY NOR AN ACROSS THE BOARD MONETARY POLICY WILL TREAT THE PROBLEM, REACH THE CAUSES OR SERVE THE INTERESTS OF THE NATION.

WE NEED SOME NEW APPROACHES, NEW POLICIES, NEW INSTITUTIONS AND SOME NEW TOOLS TO GET AT THE CURE.

SOME INSTITUTIONS AND TOOLS THAT WILL BE REQUIRED TO ADJUST TO OUR DUAL ECONOMY INCLUDE A DOMESTIC INVESTMENT AND PRODUCTION POLICY, AN INDUSTRIAL DEVELOPMENT BANK THAT WILL SERVE THE CAPITAL NEEDS OF SMALL AND MEDIUM BUSINESSES ON THE BASIS OF NATIONAL PRIORITIES, INDUSTRIAL SECTORS AND REGIONS; SELECTIVE ALLOCATION OF CREDIT, INTEREST RATE ROLL BACKS OR FREEZES, INTERNATIONAL FINANCE AND FOREIGN TRADE REFORMS, AND ADOPTION OF AN ECONOMIC AND SOCIAL POLICY THAT WILL RESTRUCTURE INVESTMENT AND PRODUCTION DECISION-MAKING PROCESSES, AND INDUCE CORPORATE ACCOUNTABILITY AND RESPONSIBILITY TO WORKERS, COMMUNITIES AND THE NATION AS A WHOLE.

BY AND LARGE, MR. CHAIRMAN, WE HAVE TO DISCARD THE FREE MARKET MYTHOLOGY THAT BLINDS US TO THE REALITIES OF ECONIMIC BEHAVIOR AND THE STRUCTURE OF THE ECONOMY.

THE MACHINISTS UNION HAS PROPOSED A REBUILDING AMERICA PROGRAM WHICH WE BELIEVE WOULD DO MUCH TO SOLVE INTEREST RATE INFLATION AS WELL AS ADDRESS ATTENDANT PROBLEMS OF ECONOMIC MALAISE.

WE BELIEVE THERE IS A WAY TO PUT AMERICAN BACK IN A WORLD LEADERSHIP ROLE WITHOUT RELYING ON SACRIFICES AND AUSTERITY.

WITH YOUR PERMISSION, MR. CHAIRMAN, I RESPECTFULLY REQUEST THAT RELATIVE PORTIONS OF THE IAM'S REBUILDING AMERICA PROPOSAL BE INCLUDED IN THE RECORD OF THIS HEARING.

THANK YOU.

PART II. CONCENTRATION ANALYSES: STOCK OWNERSHIP AND DIRECTOR INTERLOCKS

A. INTRODUCTION

Part II of the study is a series of concentration analyses covering the largest companies in each of six selected lines of business: banking, insurance, retailing, transportation, utilities and industrials. Separate analyses are included for 12 categories in the industrial area.[1] The companies were chosen by virtue of their size and rankings in the 1980 Fortune Magazine directories of the largest non-industrial and industrial companies in the United States.[2] The industries selected are among those having the most direct effect on the economy of the nation and on the lifestyles of its citizens.

The concentration analyses are specially designed for easy comparison of key data relating to possible connections among the companies in each industry grouping. The summary data describes the financial size of each company, its auditor, the six largest institutional shareholders, the relative power of their holdings, the extent of the company's director interlocks with the other firms in the study and its indirect interlocks with the companies in its group. The data has been obtained from the basic information contained in the Company Profiles and the Interlock Count Matrix, both in Part V. For a detailed description of the interlocking directorate routes between the companies, reference should be made to the listing, Direct and Indirect Interlocks, also in Part V, Appendix G.

Size.—Each analysis begins with a description of the size of the company in terms of its sales/revenues, assets, net income and number of employees.[3] This identifies the potential power and dominance of the firms in the study. By putting company size on a side-by-side basis, a quick assessment can be made of the potential strength of the companies when combined with the data on institutional ownership and boardroom interlocks. Although size by itself may not be evidence of monopoly or oligopoly power, when accompanied by concentrated ownership by large institutions and substantial director interlocks, it becomes extremely relevant in assessing the potentials for industry control.

Auditors.—Next, the concentration analyses identify each company's auditor. Who audits the largest American corporations is relevant to the matter of corporate concentration. Auditors are an indispensable part of a corporation's decision making process. Auditors have the most detailed access to the books and financial secrets of the large corporations. They are supposed to be independent watchdogs for corporate abuses. They are called in to evaluate policy decisions, to recommend corporate reorganizations, and to recruit executive personnel. Auditors provide much of the basic information that comes to the public by way of corporate disclosure. Thus, auditing firms, by the very nature of their work, may generally be considered subjects of corporate concentration.

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[1] Automotives, steel, rubber, chemicals, energy, electrical equipment, telecommunications, information processing and office equipment, aerospace and aircraft, food, tobacco, and broadcasting.

[2] Fortune Magazine: May 5, 1980, pp. 274–301; July 14, 1980, pp. 146–161.

[3] Ibid, Fortune Magazine, 1980, relevant information taken from the tables for each company. Banking data includes deposits and loans; insurance companies have premium and annuity revenues.

Institutional shareholders.—Each concentration analysis then identifies the six leading institutional shareholders in the companies under study. Equity leverage is spelled out in terms of voting percentage and percent of shares managed (investment discretion). The percentage of shares of common stock outstanding managed is cumulated as the table goes from the largest to the smallest of the holdings. Direct interlocks between holders and the portfolio companies are also noted. Such data is most significant, for it describes at a glance the extent that the largest institutional holders have individual and collective potentials for exerting their equity powers over the companies.

The analyses also set forth the total percentages of shares managed for each of three categories of shareholders in the companies: top six, next 18 institutions, and remainder of reporting institutional investors. This is an effort to provide an information base from which to judge the relative strength and cohesion of the top 6 holders as a group against the more dispersed power of the other institutional holders. In most cases the remaining institutional holdings were widely dispersed. The analysis shows an extensive degree of power residing in the top six group—a power more easily coordinated and executed by so small a number of very large holders.

In addition, the concentration analyses provide side by side comparisons from which one can identify the degree of common ownership among the companies in the industry groupings. Further, the format of summary data—which format is uniform throughout the analyses—establishes a ready means for examining the extent that certain holders also dominate the top shareholding positions across related industries.

Interlocking directorates.—The concentration analyses include a table showing the number of indirect interlocks between the competitors in the industry analyzed. These tables are similar to those included in the earlier Metcalf Subcommittee Study on interlocks. They show the degree that the companies are concentrated by having direct routes of director communication on the boards of third parties. For a definitive identification of the intermediate boards which establish these linkages and the names of the directors involved, reference should be made to the massive director interlock table contained in Part V. Appendix G.

Also included in the analyses are totals for the number of direct and indirect interlocks each company has with the other 99 companies in the study. This provides a general description of each company's potential for directorate communication across the broad scope of companies and industries in the study.

Finally, for selected industries, Part II contains computerized "criss-cross charts" displaying the extent that competitive companies meet together on the boards of their suppliers, customers, financial institutions and other related corporations.

NEW YORK BANKS

COMPANY	CITICORP	CHASE MANHATTAN CORP	MANUFACTURERS HANOVER
SIZE			
ASSETS	$106,370,619,000	$64,708,018,000	$47,575,446,000
DEPOSITS	$70,290,725,000	$48,456,210,000	$38,156,078,000
LOANS	$62,536,389,000	$39,749,569,000	$25,230,815,000
NET INCOME	$541,447,000	$303,019,000	$211,605,000
EMPLOYEES	51,600	32,510	21,165
AUDITOR	PEAT, MARWICK, MITCHELL & CO.	PEAT, MARWICK, MITCHELL & CO.	PEAT, MARWICK, MITCHELL & CO.

INSTITUTIONAL SHAREHOLDERS		VOT%	COM%	CUM%	NAME	VOT%	COM%	CUM%	NAME	VOT%	COM%	CUM%
LARGEST 6	J P MORGAN & CO INC	2.29	2.78	2.78	CITICORP	1.35	2.13	2.13	DELAWARE MANAGEMENT	2.82	3.08	3.08
	PRUDENTIAL INSURANCE	2.38	2.38	5.16	FIRST INTL BANCSHARE	1.76	1.77	3.90	‡CONTINENTAL CORPORAT	2.71	2.71	5.79
	FIRST NATL BOSTON CO	1.77	2.06	7.22	TELEDYNE INC	1.23	1.23	5.13	J P MORGAN & CO INC	.11	2.63	8.41
	PRICE T ROWE ASSOCIA	.26	1.90	9.12	MFG HANOVER CORPORAT	.93	1.19	6.32	CITICORP	1.56	2.31	10.72
	†TIAA / CREF	1.86	1.86	10.98	CALIF PUB EMP RET SY	1.19	1.19	7.50	TIAA / CREF	2.01	2.01	12.73
	BABSON DAVID L & CO		1.56	12.54	BOESKY IVAN F & COMP	.98	.98	8.48	AMERITRUST CORPORATI	1.86	1.98	14.71
SUMMARY	TOP 6 HOLDERS	8.56	12.54		TOP 6 HOLDERS	7.43	8.48		TOP 6 HOLDERS	11.06	14.71	
	NEXT 18 HOLDERS	11.84	14.66		NEXT 18 HOLDERS	9.42	12.07		NEXT 18 HOLDERS	12.20	16.99	
	ALL 207 OTHERS	19.08	23.59		ALL 115 OTHERS	10.88	14.40		ALL 109 OTHERS	9.39	13.34	

INTERLOCKS WITH FIRMS IN THE STUDY			
DIRECT	49	24	21
INDIRECT	871	514	504
INDIRECT INTERLOCKS WITHIN THE GROUP			
CITICORP	-	33	26
CHASE MANHATTAN CORP	33	-	22
MANUFACTURERS HANOVER	26	22	-
J. P. MORGAN	35	19	23
CHEMICAL NEW YORK	27	17	22
BANKERS TRUST	21	15	13

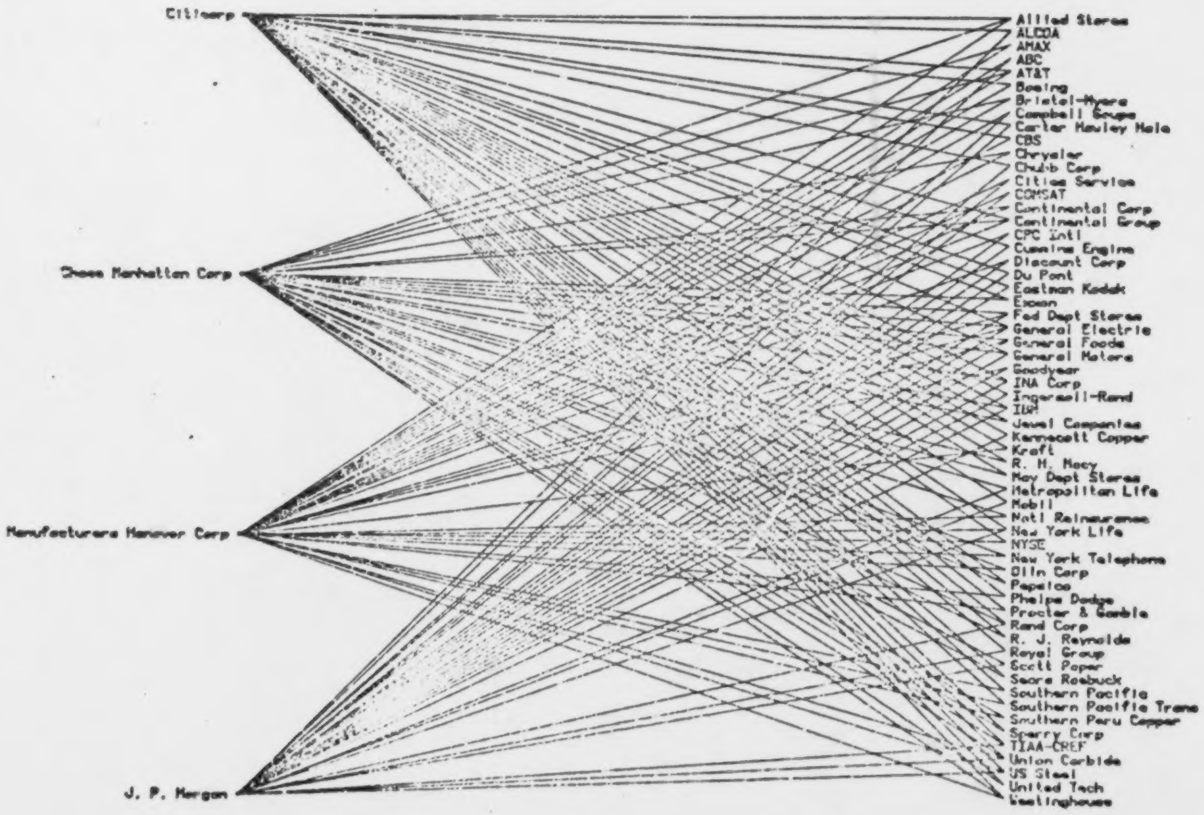
† INDICATES THE ISSUER SHARES EXACTLY ONE DIRECTOR WITH THE HOLDER AND/OR ITS SUBSIDIARIES OR AFFILIATES
‡ INDICATES THE ISSUER SHARES TWO OR MORE DIRECTORS WITH THE HOLDER AND/OR ITS SUBSIDIARIES AND AFFILIATES

NEW YORK BANKS

COMPANY					J. P. MORGAN				CHEMICAL NEW YORK				BANKERS TRUST
SIZE													
ASSETS					$43,487,679,000				$39,375,293,000				$30,852,922,000
DEPOSITS					$30;278,552,000				$28,986,820,000				$22,436,852,000
LOANS					$22,158,171,000				$20,337,991,000				$15,975,911,000
NET INCOME					$288,127,000				$134,706,000				$113,738,000
EMPLOYEES					10,831				17,494				12,671
AUDITOR					PRICE WATERHOUSE & CO.				PRICE WATERHOUSE & CO.				PRICE WATERHOUSE & CO.
INSTITUTIONAL SHAREHOLDERS			*VOT%*	*COM%*	*CUM%*	*NAME*	*VOT%*	*COM%*	*CUM%*	*NAME*	*VOT%*	*COM%*	*CUM%*
LARGEST 6	NATIONAL DETROIT CCR		2.45	3.72	3.72	CONNECTICUT GENERAL	.48	1.76	1.76	CITICORP	2.73	3.84	3.84
	PRICE T ROWE ASSOCIA		1.04	3.18	6.90	TELEDYNE INC	1.60	1.60	3.36	AMERICAN GENERAL INS	1.69	1.69	5.53
	FIRST NATL BCSTON CO		1.84	2.50	9.40	GULF & WESTERN INDS	1.46	1.46	4.82	FMR CORPORATION		1.66	7.20
	CHASE MANHATTAN CORP		1.79	2.39	11.79	BANKERS LIFE COMPANY	1.35	1.35	6.17	MARYLAND NATIONAL CO	1.49	1.49	8.69
	BANKAMERICA CORPGRAT		1.07	1.62	13.41	CITICORP	.18	1.13	7.29	INSTITUTIONAL CAP CO	.28	1.14	9.83
	CONTINENTAL CORPORAT		1.50	1.50	14.91	FIRESTONE PENSION PL	1.08	1.08	8.37	†CONTINENTAL CORPORAT	.88	.88	10.71
SUMMARY	TOP 6 HOLDERS		9.68	14.91		TOP 6 HOLDERS	6.14	8.37		TOP 6 HOLDERS	7.07	10.71	
	NEXT 18 HOLDERS		11.14	16.87		NEXT 18 HOLDERS	9.59	12.16		NEXT 18 HOLDERS	3.94	7.64	
	ALL 174 OTHERS		18.72	23.83		ALL 49 OTHERS	4.04	5.35		ALL 38 OTHERS	2.23	2.75	
INTERLOCKS WITH FIRMS IN THE STUDY													
DIRECT					31				24				16
INDIRECT					625				588				476
INDIRECT INTERLOCKS WITHIN THE GROUP													
CITICORP					35				27				21
CHASE MANHATTAN CORP					19				17				15
MANUFACTURERS HANOVER					23				22				13
J. P. MORGAN					-				25				9
CHEMICAL NEW YORK					25				-				26
BANKERS TRUST					9				26				-

† INDICATES THE ISSUER SHARES EXACTLY ONE DIRECTOR WITH THE HOLDER AND/OR ITS SUBSIDIARIES OR AFFILIATES

NEW YORK BANKS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J. P. Morgan
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AT&T
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Carter Hawley Hale
CBS
Chrysler
Chubb Corp
Cities Service
COMSAT
Continental Corp
Continental Group
CPC Intl
Cummins Engine
Discount Corp
Du Pont
Eastman Kodak
Exxon
Fed Dept Stores
General Electric
General Foods
General Motors
Goodyear
INA Corp
Ingersoll-Rand
IBM
Jewel Companies
Kennecott Copper
Kraft
R. H. Macy
May Dept Stores
Metropolitan Life
Mobil
Natl Reinsurance
New York Life
NYSE
New York Telephone
Olin Corp
Pepsico
Phelps Dodge
Procter & Gamble
Rand Corp
R. J. Reynolds
Royal Group
Scott Paper
Sears Roebuck
Southern Pacific
Southern Pacific Trans
Southern Peru Copper
Sperry Corp
TIAA-CREF
Union Carbide
US Steel
United Tech
Westinghouse

CALIFORNIA BANKS

COMPANY				BANKAMERICA				WESTERN BANCORPORATION				SECURITY PACIFIC
SIZE												
ASSETS				$108,369,318,000				$29,687,134,000				$24,923,382,000
DEPOSITS				$84,984,746,000				$23,631,073,000				$18,450,827,000
LOANS				$57,096,295,000				$16,813,824,000				$16,145,246,000
NET INCOME				$600,203,000				$203,342,000				$163,580,000
EMPLOYEES				80,959				29,097				23,701
AUDITOR				ERNST & WHINNEY				ERNST & WHINNEY				PEAT, MARWICK, MITCHELL & CO.
INSTITUTIONAL SHAREHOLDERS		*VOT%*	*COM%*	*CUM%*	*NAME*	*VOT%*	*COM%*	*CUM%*	*NAME*	*VOT%*	*COM%*	*CUM%*
LARGEST 6	J P MORGAN & CO INC	1.03	1.65	1.65	BANKAMERICA CORPORAT	2.56	3.56	3.56	TELEDYNE INC	3.99	3.99	3.99
	CALIF PUB EMP RET SY	1.52	1.52	3.17	WELLINGTON MANAGEMEN	.21	2.99	6.56	NATIONAL DETROIT COR	1.74	2.59	6.58
	TELEDYNE INC	1.35	1.35	4.52	PRUDENTIAL INSURANCE	2.49	2.49	9.05	#SECURITY PACIFIC COR	2.32	2.53	9.10
	CITICORP	.74	1.28	5.80	STATE FM MUT AUT INS	2.21	2.21	11.26	DELAWARE MANAGEMENT	2.06	2.16	11.26
	PRUDENTIAL INSURANCE	1.05	1.05	6.85	UNIVERSITY OF CALIFO	2.09	2.09	13.35	WELLS FARGO & COMPAN	1.55	1.92	13.19
	BANCAL TRI-STATE COR	.14	1.04	7.90	MASS FINANCIAL SERVI	.04	2.07	15.42	STATE FM MUT AUT INS	1.67	1.67	14.86
SUMMARY	TOP 6 HOLDERS	5.83	7.90		TOP 6 HOLDERS	9.60	15.42		TOP 6 HOLDERS	13.33	14.86	
	NEXT 18 HOLDERS	8.43	12.40		NEXT 18 HOLDERS	15.71	19.27		NEXT 18 HOLDERS	8.84	15.48	
	ALL 190 OTHERS	11.68	13.04		ALL 105 OTHERS	11.58	14.54		ALL 58 OTHERS	5.14	7.07	
INTERLOCKS WITH FIRMS IN THE STUDY												
DIRECT				15				12				8
INDIRECT				395				254				164
INDIRECT INTERLOCKS WITHIN THE GROUP												
BANKAMERICA				-				13				9
WESTERN BANCORPORATION				13				-				17
SECURITY PACIFIC				9				17				-
WELLS FARGO & CO.				17				11				5
CROCKER NATIONAL				14				9				4

# INDICATES THE ISSUER SHARES TWO OR MORE DIRECTORS WITH THE HOLDER AND/OR ITS SUBSIDIARIES AND AFFILIATES

CALIFORNIA BANKS

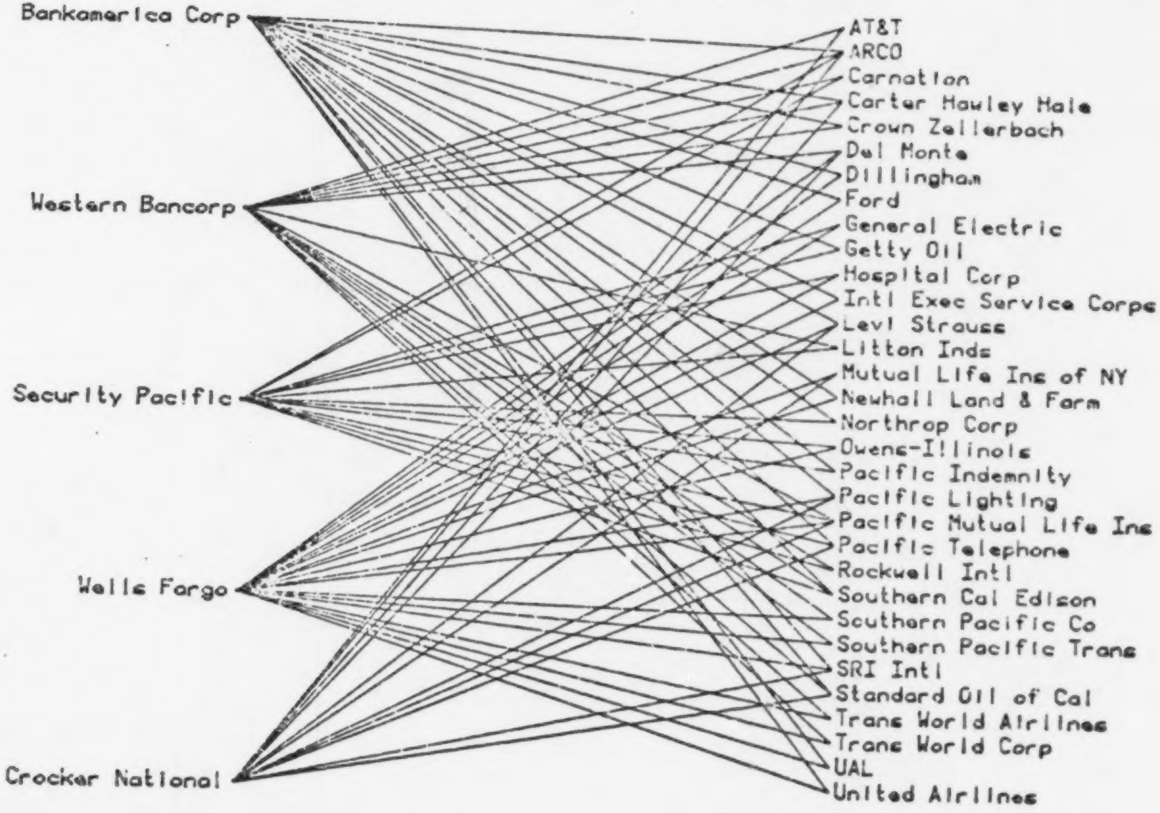
COMPANY	WELLS FARGO & CO.	CROCKER NATIONAL
SIZE		
ASSETS	$20,593,124,000	$16,138,650,000
DEPOSITS	$15,831,015,000	$12,516,820,000
LOANS	$14,735,678,000	$10,433,489,000
NET INCOME	$123,416,000	$116,898,000
EMPLOYEES	17,451	16,311
AUDITOR	PEAT, MARWICK, MITCHELL & CO.	ARTHUR ANDERSEN & CO.

INSTITUTIONAL	SHAREHOLDERS	VOT%	COM%	CUM%	NAME	VOT%	COM%	CUM%
LARGEST 6	‡WELLS FARGO & COMPAN	4.92	4.96	4.95	DELAWARE MANAGEMENT	4.44	4.72	4.72
	TELEDYNE INC	4.82	4.82	9.78	PRICE T ROWE ASSOCIA	2.89	4.28	8.99
	STATE FM MUT AUT INS	4.14	4.14	13.93	‡CROCKER NATIONAL COR	2.16	2.95	11.94
	TIAA / CREF	3.21	3.21	17.14	CALIF PUB EMP RET SY	2.23	2.23	14.18
	CROCKER NATIONAL COR	1.78	2.66	19.80	DODGE & COX	1.75	1.75	15.93
	ROSENBERG CAPITAL MG	2.47	2.47	22.27	WISCONSIN INVESTMT B	1.54	1.54	17.47
SUMMARY	TOP 6 HOLDERS	21.35	22.27		TOP 6 HOLDERS	15.01	17.47	
	NEXT 18 HOLDERS	15.07	22.02		NEXT 18 HOLDERS	7.09	8.71	
	ALL 53 OTHERS	6.92	9.51		ALL 32 OTHERS	2.05	3.34	

INTERLOCKS WITH FIRMS IN THE STUDY	WELLS FARGO & CO.	CROCKER NATIONAL
DIRECT	9	9
INDIRECT	342	301
INDIRECT INTERLOCKS WITHIN THE GROUP		
BANKAMERICA	17	14
WESTERN BANCORPORATION	11	9
SECURITY PACIFIC	5	4
WELLS FARGO & CO.	-	11
CROCKER NATIONAL	11	-

‡ INDICATES THE ISSUER SHARES TWO OR MORE DIRECTORS WITH THE HOLDER AND/OR ITS SUBSIDIARIES AND AFFILIATES

CALIFORNIA BANKS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Security Pacific
Wells Fargo
Crocker National
AT&T
ARCO
Carnation
Carter Hawley Hale
Crown Zellerbach
Del Monte
Dillingham
Ford
General Electric
Getty Oil
Hospital Corp
Intl Exec Service Corps
Levi Strauss
Litton Inds
Mutual Life Ins of NY
Newhall Land & Farm
Northrop Corp
Owens-Illinois
Pacific Indemnity
Pacific Lighting
Pacific Mutual Life Ins
Pacific Telephone
Rockwell Intl
Southern Cal Edison
Southern Pacific Co
Southern Pacific Trans
SRI Intl
Standard Oil of Cal
Trans World Airlines
Trans World Corp
UAL
United Airlines

INTENTIONAL
BLANK

MIDWESTERN BANKS

COMPANY					CONTINENTAL ILLINOIS				FIRST CHICAGO				HARRIS BANKCORP
SIZE													
ASSETS					$35,790,119,000				$30,181,800,000				$7,107,759,000
DEPOSITS					$24,007,200,000				$21,106,060,000				$4,928,932,000
LOANS					$22,861,532,000				$15,563,358,000				$3,274,876,000
NET INCOME					$195,807,000				$112,041,000				$16,463,000
EMPLOYEES					11,770				10,207				3,768
AUDITOR					ERNST & WHINNEY				ARTHUR ANDERSEN & CO.				ARTHUR ANDERSEN & CO.
INSTITUTIONAL SHAREHOLDERS		VOT%	COM%	CUM%	NAME	VOT%	COM%	CUM%	NAME	VOT%	COM%	CUM%	
LARGEST 6	LORD ABBETT & COMPAN	2.92	2.92	2.92	‡FIRST CHICAGO CORP	6.10	7.26	7.26	‡HARRIS BANKCORP	22.55	22.67	22.67	
	PRUDENTIAL INSURANCE	2.84	2.84	5.77	TELEDYNE INC	2.34	2.34	9.60	CITICORP	2.16	2.80	25.46	
	CITICORP	1.32	2.72	8.49	NORTHERN TRUST CORP	1.87	2.31	11.91	DODGE & COX	2.65	2.65	28.11	
	FIRST CHICAGO CORP	2.19	2.30	11.09	UNIVERSITY OF CALIFO	2.27	2.27	14.18	SCUDDER STEVENS & CL		2.53	30.64	
	MFG HANOVER CORPORAT	.01	2.51	13.60	CHASE MANHATTAN CORP	1.73	1.81	15.99	IT&T	2.35	2.35	32.99	
	N Y STATE TEACHERS R	2.19	2.19	15.79	BANCAL TRI-STATE COR	1.75	1.77	17.76	LOEWS CORPORATION	2.26	2.26	35.25	
SUMMARY	TOP 6 HOLDERS	11.48	15.79		TOP 6 HOLDERS	16.07	17.76		TOP 6 HOLDERS	31.96	35.25		
	NEXT 18 HOLDERS	16.54	23.99		NEXT 18 HOLDERS	10.68	16.70		NEXT 18 HOLDERS	13.11	14.37		
	ALL 111 OTHERS	15.33	19.14		ALL 76 OTHERS	7.49	9.62		ALL 14 OTHERS	1.07	1.49		
INTERLOCKS WITH FIRMS IN THE STUDY													
DIRECT				13				20				9	
INDIRECT				358				392				229	
INDIRECT INTERLOCKS WITHIN THE GROUP													
CONTINENTAL ILLINOIS				-				36				21	
FIRST CHICAGO				36				-				19	
HARRIS BANKCORP				21				19				-	
NORTHWEST BANCORPORATION				3				6				4	
FIRST BANK SYSTEM				3				0				6	
NATIONAL DETROIT				0				0				1	

‡ INDICATES THE ISSUER SHARES TWO OR MORE DIRECTORS WITH THE HOLDER AND/OR ITS SUBSIDIARIES AND AFFILIATES

MIDWESTERN BANKS

COMPANY	NORTHWEST BANCORPORATION	FIRST BANK SYSTEM	NATIONAL DETROIT
SIZE			
ASSETS	$12,415,823,000	$12,118,450,000	$9,506,400,000
DEPOSITS	$5,573,230,000	$8,982,846,000	$6,896,142,000
LOANS	$7,443,553,000	$6,785,968,000	$4,543,246,000
NET INCOME	$106,642,000	$101,691,000	$76,604,000
EMPLOYEES	12,552	9,090	6,496
AUDITOR	PEAT, MARWICK, MITCHELL & CO.	ERNST & WHINNEY	TOUCHE ROSS & CO.

INSTITUTIONAL SHAREHOLDERS

NORTHWEST BANCORPORATION

LARGEST 6	VOT%	COM%	CUM%
‡NORTHWEST BANCORPORA	5.40	5.64	5.64
FIRST BANKSYSTEM INC	2.74	4.32	9.96
US STEEL & CARNEGIE	3.95	3.95	13.92
NATIONAL DETROIT COR	2.11	2.95	16.86
FIRST CHICAGO CORP	2.61	2.86	19.72
STEIN ROE & FARNHAM	.55	2.07	21.78
SUMMARY			
TOP 6 HOLDERS	17.37	21.79	
NEXT 18 HOLDERS	18.06	21.18	
ALL 75 OTHERS	9.90	13.36	

FIRST BANK SYSTEM

NAME	VOT%	COM%	CUM%
‡FIRST BANKSYSTEM INC	3.09	11.12	11.12
NATIONAL DETROIT COR	2.62	4.42	15.54
STEIN ROE & FARNHAM	.74	2.49	18.03
US STEEL & CARNEGIE	2.45	2.45	20.48
†FIRST CHICAGO CORP	2.14	2.35	22.83
CITICORP	.59	1.67	24.50
TOP 6 HOLDERS	11.64	24.50	
NEXT 18 HOLDERS	12.85	17.77	
ALL 56 OTHERS	6.57	8.61	

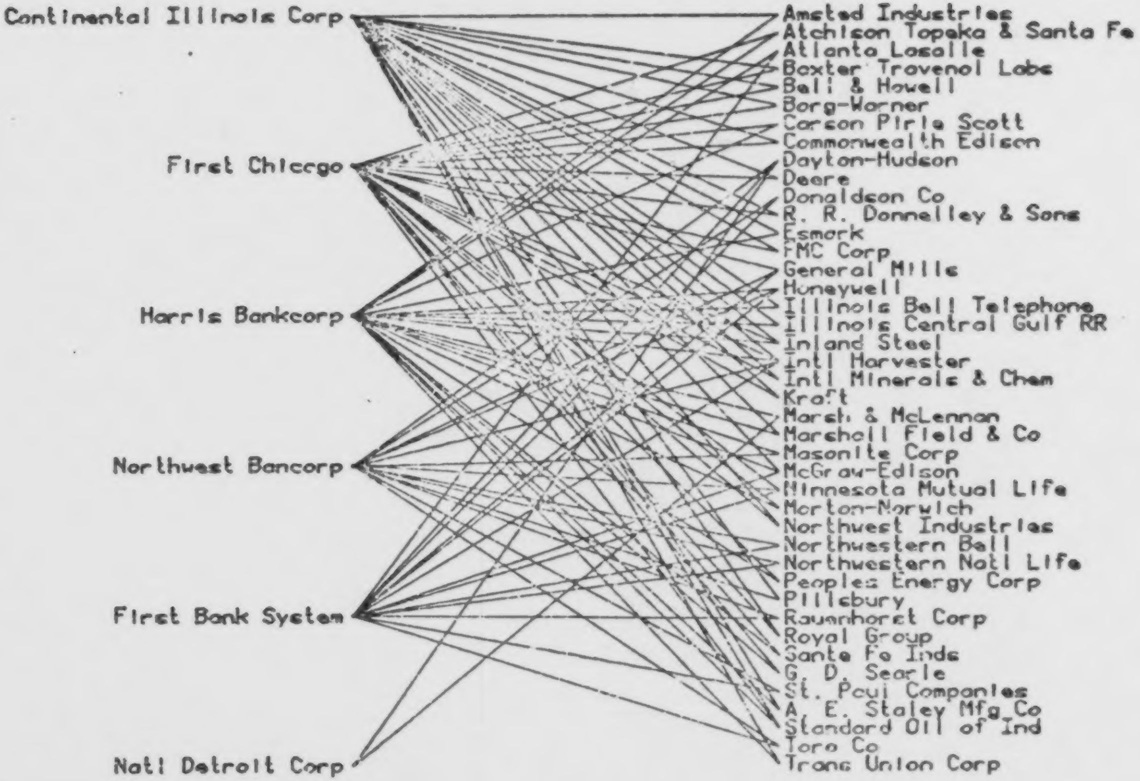
NATIONAL DETROIT

NAME	VOT%	COM%	CUM%
STATE FM MUT AUT INS	5.94	5.94	5.94
‡NATIONAL DETROIT COR	3.79	5.45	11.40
FUND RESEARCH & MGMT	4.40	4.92	16.32
BERKSHIRE HATHAWAY I	3.39	3.39	19.71
US STEEL & CARNEGIE	2.81	2.81	22.52
NATIONWIDE MUTUAL IN	2.06	2.06	24.57
TOP 6 HOLDERS	22.30	24.57	
NEXT 18 HOLDERS	8.21	9.60	
ALL 10 OTHERS	.26	.58	

	NORTHWEST BANCORPORATION	FIRST BANK SYSTEM	NATIONAL DETROIT
INTERLOCKS WITH FIRMS IN THE STUDY			
DIRECT	2	6	8
INDIRECT	160	157	136
INDIRECT INTERLOCKS WITHIN THE GROUP.			
CONTINENTAL ILLINOIS	3	3	0
FIRST CHICAGO	6	0	0
HARRIS BANKCORP	4	6	1
NORTHWEST BANCORPORATION	-	29	1
FIRST BANK SYSTEM	29	-	1
NATIONAL DETROIT	1	1	-

† INDICATES THE ISSUER SHARES EXACTLY ONE DIRECTOR WITH THE HOLDER AND/OR ITS SUBSIDIARIES OR AFFILIATES
‡ INDICATES THE ISSUER SHARES TWO OR MORE DIRECTORS WITH THE HOLDER AND/OR ITS SUBSIDIARIES AND AFFILIATES

MIDWESTERN BANKS


Continental Illinois Corp
First Chicago
Harris Bankcorp
Northwest Bancorp
First Bank System
Natl Detroit Corp
Amsted Industries
Atchison Topeka & Santa Fe
Atlanta Lasalle
Baxter Travenol Labs
Bell & Howell
Borg-Warner
Carson Pirie Scott
Commonwealth Edison
Dayton-Hudson
Deere
Donaldson Co
R. R. Donnelley & Sons
Esmark
FMC Corp
General Mills
Honeywell
Illinois Bell Telephone
Illinois Central Gulf RR
Inland Steel
Intl Harvester
Intl Minerals & Chem
Kraft
Marsh & McLennan
Marshall Field & Co
Masonite Corp
McGraw-Edison
Minnesota Mutual Life
Morton-Norwich
Northwest Industries
Northwestern Bell
Northwestern Natl Life
Peoples Energy Corp
Pillsbury
Rauenhorst Corp
Royal Group
Sante Fe Inds
G. D. Searle
St. Paul Companies
A. E. Staley Mfg Co
Standard Oil of Ind
Toro Co
Trans Union Corp

LIFE INSURANCE

COMPANY	PRUDENTIAL	METROPOLITAN LIFE	EQUITABLE LIFE ASSURANCE
SIZE			
PREMIUM AND ANNUITY REVENUES	$8,007,951,000	$5,934,722,000	$4,576,910,000
NET INVESTMENT INCOME	$3,313,429,000	$3,088,872,000	$1,808,910,000
ASSETS	$54,734,107,000	$44,967,563,000	$30,839,211,000
NET INCOME	$278,398,000	$233,912,000	$77,024,000
EMPLOYEES	61,942	51,000	25,470
AUDITOR	TOUCHE ROSS & CO.	DELOITTE HASKINS & SELLS	DELOITTE HASKINS & SELLS
INTERLOCKS WITH FIRMS IN THE STUDY			
DIRECT	6	24	11
INDIRECT	311	669	479
INDIRECT INTERLOCKS WITHIN THE GROUP			
PRUDENTIAL	-	10	3
METROPOLITAN LIFE	10	-	12
EQUITABLE LIFE ASSURANCE	3	12	-
AETNA LIFE & CASUALTY	0	9	6
NEW YORK LIFE	5	19	9
JOHN HANCOCK MUTUAL LIFE	11	13	11

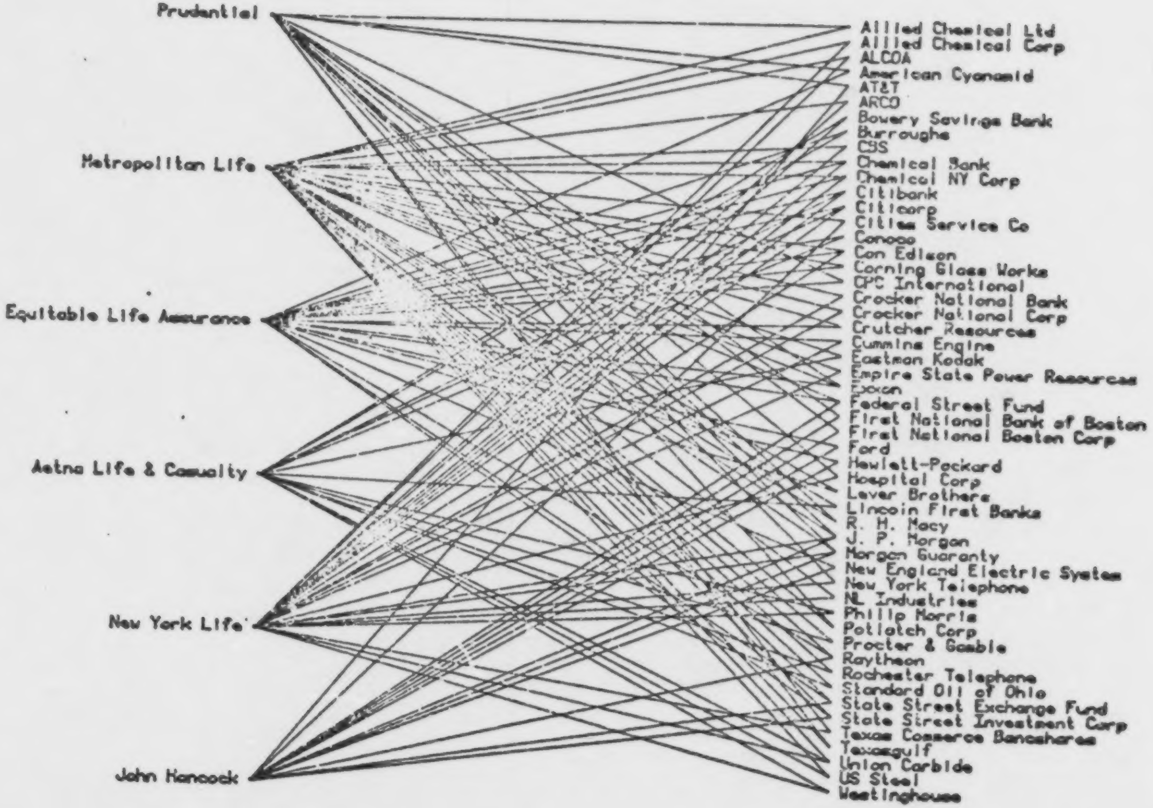
LIFE INSURANCE

COMPANY	AETNA LIFE & CASUALTY	NEW YORK LIFE	JOHN HANCOCK MUTUAL LIFE
SIZE			
REVENUES	$11,446,880,000		
PREMIUM AND ANNUITY REVENUES		$2,598,658,000	$2,107,657,000
NET INVESTMENT INCOME		$1,235,376,000	$1,150,511,000
ASSETS	$30,228,463,000	$18,479,224,000	$17,318,502,000
NET INCOME	$585,418,000	$151,444,000	$144,366,000
EMPLOYEES	37,540	19,889	20,400
AUDITOR	PEAT, MARWICK, MITCHELL & CO.	PRICE WATERHOUSE & CO.	ERNST & WHINNEY

INSTITUTIONAL SHAREHOLDERS		*VOT%*	*COM%*	*CUM%*	*NAME*	*VOT%*	*COM%*	*CUM%*	*NAME*	*VOT%*	*COM%*	*CUM%*
LARGEST 6	TELEDYNE INC	5.00	5.01	5.01								
	FAYEZ SAROFIM & COMP	3.36	3.36	8.37								
	†HARTFORD NATIONAL CO	2.91	3.07	11.44								
	TIAA / CREF	2.74	2.74	14.18								
	US STEEL & CARNEGIE	2.55	2.55	16.74								
	†CBT CORPORATION	1.75	1.81	18.54								
SUMMARY	TOP 6 HOLDERS	18.32	18.54		TOP 6				TOP 6			
	NEXT 18 HOLDERS	8.59	15.30		NEXT 18				NEXT 18			
	ALL 189 OTHERS	13.41	18.69		OTHER				OTHER			

	AETNA LIFE & CASUALTY	NEW YORK LIFE	JOHN HANCOCK MUTUAL LIFE
INTERLOCKS WITH FIRMS IN THE STUDY			
DIRECT	11	21	9
INDIRECT	257	606	257
INDIRECT INTERLOCKS WITHIN THE GROUP			
PRUDENTIAL	0	5	11
METROPOLITAN LIFE	9	19	13
EQUITABLE LIFE ASSURANCE	6	9	11
AETNA LIFE & CASUALTY	-	7	0
NEW YORK LIFE	7	-	2
JOHN HANCOCK MUTUAL LIFE	0	2	-

LIFE INSURANCE


Prudential
Metropolitan Life
Equitable Life Assurance
Aetna Life & Casualty
New York Life
John Hancock
Allied Chemical Ltd
Allied Chemical Corp
ALCOA
American Cyanamid
AT&T
ARCO
Bowery Savings Bank
Burroughs
CBS
Chemical Bank
Chemical NY Corp
Citibank
Citicorp
Cities Service Co
Conoco
Con Edison
Corning Glass Works
CPC International
Crocker National Bank
Crocker National Corp
Crutcher Resources
Cummins Engine
Eastman Kodak
Empire State Power Resources
Exxon
Federal Street Fund
First National Bank of Boston
First National Boston Corp
Ford
Hewlett-Packard
Hospital Corp
Lever Brothers
Lincoin First Banks
R. H. Macy
J. P. Morgan
Morgan Guaranty
New England Electric System
New York Telephone
NL Industries
Philip Morris
Potlatch Corp
Procter & Gamble
Raytheon
Rochester Telephone
Standard Oil of Ohio
State Street Exchange Fund
State Street Investment Corp
Texas Commerce Bancshares
Texasgulf
Union Carbide
US Steel
Westinghouse

DIVERSIFIED FINANCIAL COMPANIES

COMPANY	AETNA LIFE & CASUALTY				TRAVELERS				AMERICAN EXPRESS			
SIZE												
REVENUES				$11,446,880,000				$7,868,901,000				$4,666,500,000
ASSETS				$30,228,453,000				$19,159,864,000				$17,108,200,000
NET INCOME				$585,418,000				$395,046,000				$345,300,000
EMPLOYEES				37,540				29,166				40,732
AUDITOR	PEAT, MARWICK, MITCHELL & CO.				COOPERS & LYBRAND				ARTHUR YOUNG & CO.			
INSTITUTIONAL SHAREHOLDERS		*VOT%*	*COM%*	*CUM%*	*NAME*	*VOT%*	*COM%*	*CUM%*	*NAME*	*VOT%*	*COM%*	*CUM%*
LARGEST 6	TELEDYNE INC	5.00	5.01	5.01	TIAA / CREF	4.94	4.99	4.99	NATIONAL DETROIT COR	3.80	3.98	3.98
	FAYEZ SAROFIM & COMP	3.36	3.36	8.37	TELEDYNE INC	5.25	4.84	9.34	FAYEZ SAROFIM & COMP	3.23	3.23	7.21
	†HARTFORD NATIONAL CO	2.91	3.07	11.44	†HARTFORD NATIONAL CO	3.27	3.40	13.23	STATE STREET RES & M	2.38	2.51	9.72
	TIAA / CREF	2.74	2.74	14.18	FMR CORPORATION		2.87	16.11	†CHASE MANHATTAN CORP	1.79	2.13	11.84
	US STEEL & CARNEGIE	2.55	2.55	16.74	CBT CORPORATION	2.35	2.39	18.49	BABSON DAVID L & CO		1.94	13.78
	†CBT CORPORATION	1.75	1.81	18.54	GENERAL ELECTRIC COM	2.17	2.20	20.63	EQUITABLE LIFE ASSUR	1.72	1.72	15.50
SUMMARY	TOP 6 HOLDERS	18.32	18.54		TOP 6 HOLDERS	17.98	20.69		TOP 6 HOLDERS	12.91	15.50	
	NEXT 18 HOLDERS	8.59	15.30		NEXT 18 HOLDERS	15.05	22.08		NEXT 18 HOLDERS	11.66	19.73	
	ALL 189 OTHERS	13.41	18.69		ALL 136 OTHERS	9.85	14.64		ALL 168 OTHERS	14.56	20.12	
INTERLOCKS WITH FIRMS IN THE STUDY												
DIRECT				11				1				20
INDIRECT				257				93				504
INDIRECT INTERLOCKS WITHIN THE GROUP												
AETNA LIFE & CASUALTY				-				3				4
TRAVELERS				3				-				5
AMERICAN EXPRESS				4				5				-
INA				3				2				6

† INDICATES THE ISSUER SHARES EXACTLY ONE DIRECTOR WITH THE HOLDER AND/OR ITS SUBSIDIARIES OR AFFILIATES

DIVERSIFIED FINANCIAL COMPANIES

COMPANY					INA
SIZE					
REVENUES					$4,551,372,000
ASSETS					$8,987,035,000
NET INCOME					$261,637,000
EMPLOYEES					35,280
AUDITOR					ARTHUR YOUNG & CO.
INSTITUTIONAL SHAREHOLDERS			VOT%	COM%	CUM%
LARGEST 6	DELAWARE MANAGEMENT		3.00	4.16	4.16
	NATIONAL DETROIT COR		3.19	3.53	7.69
	PROVIDENT NATIONAL C		2.66	3.24	10.93
	MARSH & MCLENNAN COM			3.10	14.03
	†CHASE MANHATTAN CORP		1.93	2.24	16.27
	TIAA / CREF		1.85	1.85	16.12
SUMMARY	TOP 6 HOLDERS	12.64	18.12		
	NEXT 13 HOLDERS	13.73	21.77		
	ALL 103 OTHERS	10.50	13.16		
INTERLOCKS WITH FIRMS IN THE STUDY					
DIRECT					9
INDIRECT					322
INDIRECT INTERLOCKS WITHIN THE GROUP					
AETNA LIFE & CASUALTY					3
TRAVELERS					2
AMERICAN EXPRESS					6
INA					-

† INDICATES THE ISSUER SHARES EXACTLY ONE DIRECTOR WITH THE HOLDER AND/OR ITS SUBSIDIARIES OR AFFILIATES

Rebuilding America Act of 1981

Worker Productive Parity

Fair and Reciprocal Trade

It is the purpose of this title to (a) make efficient and give cohesive direction and purpose to the nation's international trade policy, (b) by providing American workers with the means to achieve productive parity with foreign workers, who have advantages of national economic and social planning to promote growth and full employment in the context of free flowing world economic trade.

In order to achieve the purposes of (a) above, the International Trade Agency is created.

The Agency will have exclusive responsibility within the Executive Branch for trade policy formulation and implementation, enforcement and negotiations.

The agency will assume the international trade functions from the Departments of Commerce, Labor, State and Treasury, the United States Trade Representative, and corollary offices and independent agencies, including the U.S. Customs Service, the United States Export-Import Bank, the United States International Trade Commission, and the Economic Support Fund, Trade and Development Program, Food for Peace Program (P.L. 480), and Overseas Private Investment Corporation of the International Development Cooperation Agency.

The Agency will have a Director, nominated and appointed by the President, with the advice and consent of the Senate and concurrence by a simple majority of the members of the House of Representatives Ways and Means Committee.

The Director will serve at the will and pleasure of the President, be granted Cabinet level status, conferred Ambassadorial rank, with salary and perks commensurate.

The Agency will have the following offices, each headed by a Deputy Director, nominated and appointed by the President with the advice and consent of the Senate:

(a) Transition and Interagency Cooperation
(b) Congressional Liaison
(c) Labor Industrial Sector
(d) Export Promotion and Priorities
(e) Import Review and Policy
(f) Trade Negotiations, Agreements and Enforcement
(g) Multinational Corporation Monitor
(h) Intermediate and Small Business Assistance
(i) Third and Fourth World Aid and Trade
(j) East-West Trade
(k) Tax Policy Review and Recommendations
(l) Appeals and Grievances

Each Deputy Director will report directly to the Director, and be given status, salary and perks commensurate with the Deputy Secretary level.

A. The duties of the Deputy Director for Transition and Interagency Cooperation are apparent on their face, and the office will be abolished upon completion of these duties, when the International Trade Agency is established and functioning.

B. It will be the duty of the Deputy Director for Congressional Liaison to (1) keep the Congress fully informed of the activities, programs, problems and progress of the Agency and its offices (2) keep the Director and Deputy

Directors informed of Congressional actions and sentiments with respect to legislation and policy formulation (3) prepare and present a proposed international trade legislative agenda for the President to present to the Congress and the people each year.

C. The Deputy Director for the Labor Industrial Sector will be a bona fide trade union member, experienced in collective bargaining and trade union administration.

During interim vacancies in the Agency Director's office or during extended absences by the Director, the Deputy Director for the Labor Industrial Sector will serve as Acting Director for the International Trade Agency.

It will be the first duty of the Deputy Director for the Labor Industrial Sector to develop an economic and social clause on which to base international trade policy and programs that will (1) promote domestic full employment and economic growth (2) preserve and strengthen the nation's industrial base (3) improve productive parity and, hence, productivity (4) link and tie U.S. trade and aid to the promotion of economic and social justice for workers abroad, as well as at home, with emphasis on guaranteed democratic human and trade union rights, fair distribution of wealth and income, safeguards against environmental, health and safety hazards, the promotion of international peace and freedom from oppression and exploitation, whatever the source.

The economic and social clause principles will be incorporated into all activities and decisions made by the Agency and its offices, and will be negotiated into all private and public trade agreements in which the U.S. government or private entities are a party.

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C-1. The Deputy Director for the Labor Industrial Sector will appoint a 25-member Labor Industrial Sector Board comprised of 25 trade union members, with hands-on production and collective bargaining experience.

The Board will function as an autonomous fact finding and recommending body to the Agency.

It will have subpoena powers for those purposes.

The Deputy Director for the Labor Industrial Sector will chair the Board.

Each Board member will, in turn, chair and be responsible for the activities of one of the following Industrial Sector Committees:

Aerospace

Air Transport

Alumium, Copper and Non-ferrous Mining and Manufacturing

Automotive and Automotive Supply

Building Construction Materials and Equipment

Chemical

Communications and Communications Satellite

Electrical Equipment

Electronics and Microprocessing

Energy and Fuels - Fossil

Energy Sources - Renewable

Exotic Minerals and Metals

Food and Fiber Production and Processing

Heavy and Industrial Construction Equipment

Machine and Manufacturing

Machine Tool and Tool and Die

Marine, Shipbuilding and Water Transport

Medical Equipment, Medicines and Pharmaceuticals

Mining

Oceanology

Plastics

Rail Equipment and Rail Transport

Rubber

Steel, Iron and Alloys

- Advanced R & D and New Products

C-2. The Board, through each of its committees, will canvass and survey the basic and major manufacturing and industrial sectors to determine the condition and status of each and compare those findings with conditions in other industrialized and developing nations.

C-3. The Board will make short run and long run forecasts on the strengths and weaknesses of the industrial sectors, including structure of ownership and control, financial condition, market shares, trends and potential, raw material supplies and costs, state of technology and employment and earnings forecasts.

C-4. The Board will develop an agenda of national industrial priorities, consistent with the economic and social clause.

C-5. In cases of failing companies, or industries threatened with extinction, the Board will have the duty and power to recommend either (a) public ownership including community/worker ownership, or nationalization (b) taxpayer subsidies or their elimination or government-private joint ventures (c) taxpayer loans or loan guarantees (d) acquisition or merger (e) consolidation (f) divestiture (g) bankruptcy (h) liquidation - all consistent with the economic and social plan.

In the case of runaway firms or plants, transfers of capital or technology, or licensing or Co-production agreements, the Board will have the duty and power to recommend either affirmatively or negatively, in consonance with the economic and social clause objectives.

C-6. The Board, in cases of economic dislocation, including those that are a result of imports and import policy will prepare local employment, income and economic impact analyses and develop an economic reconstruction plan to (1) protect workers' income and health benefits, (2) provide job security, job training and continuity of employment and (3) to make the impacted local economy viable.

(Trade Adjustment Assistance Act may be incorporated into this plan).

C-7. The Board will monitor multinational corporate behavior with respect to human rights, labor relations and trade union rights and the other components of the economic and social clause.

C-8. The Board will cooperate with the International Trade Union Secretariats, domestic and foreign central trade union bodies and may assist in forming ad hoc international trade union councils on either company or regional bases, to fulfill its duties and obligations under this Act.

C-9. The Board will avail itself of the resources of appropriate domestic and foreign government offices and the various international economic and social agencies.

C-10. The Board will submit to the Director and the Congress and make public biennial reports on its activities, findings and recommendation.

Board Committee Chairs will be considered top level federal management executives and entitled to the same salary and perks.

D. The Deputy Director for Export Promotion and Priorities will be responsible for the functions of the Commerce Department related to export promotion, the U.S. Export-Import Bank, Overseas Private Investment Corporation and those grain, food and fiber export programs now administered by the Department of Agriculture and International Development Cooperation Agency.

D-1. The first duty of the Deputy Director for Export Promotion and Priorities will be to conduct a global survey and canvass of corporate, international development and finance agency, and national strategies and tactics, with respect to U.S. economic and trade priorities in terms of (a) marketing objectives (b) price and pricing policies (c) tariffs (d) non-tariff barriers to imports (e) export promotions, incentives and subsidies (f) direct foreign investment (g) foreign domestic investment (h) industrial R & D, technology transfers, licensing and co-production agreements and introduction of new technology (i) new products and services (j) bilateral trade agreements and bilateral development assistance (k) multilateral trade agreements and development programs (l) participation in the World Bank, International Development Banks and the International Monetary Fund (m) floating exchange rates and foreign money markets and (n) tax havens.

D-2. The Deputy Director for Export Promotion and Priorities will review all U.S. government programs, regulations, trade agreements and development assistance programs affecting exports of capital, technology, goods and services to identify: (a) bureaucratic overlap (b) regulation gaps or the need for deregulation (c) hidden trade barriers (d) trade incentives and (e) failures or successes and their causes in achieving the objectives of such regulations, agreements and development assistance programs.

D-3. The Deputy Director for Export Promotion will report the findings of the global survey and the U.S. government policy review to the International Trade Agency Director and the Congress, along with recommendations to improve same.

D-4. Consistent with the Economic and Social clause developed by the Labor Industrial Sector Board, and in consultation with other relevant offices of the Agency, the Deputy Director for Export Promotion and Priorities will then prepare a schedule of Export Priorities, objectives and the means to achieve them.

D-5. The Deputy Director for Export Promotion and Priorities will have licensing authority for all exports of capital, technology, patents, trademarks, plant and equipment and will grant or deny the same, after taking into consideration the Economic and Social Plan and with the concurrence of the Deputy Director for the Labor Industrial Sectors.

D-5(a). In event of a dispute or impasse, the International Trade Agency Director will rule.

E. The Deputy Director for Import Review and Policy will absorb the functions of the U.S. International Trade Commission and the Import Administration of the U.S. Department of Commerce.

E-1 The first duty of the Deputy Director for Import Review and Policy will be to canvass and survey each U.S. Government sanctioned program, regulation, trade agreement and development assistance program affecting imports, in order to identify (1) bureaucratic overlap (2) import barriers and import incentives and their rationale (3) their impact on the economy in terms of balance of payments, industrial sector strength, strategic necessity, employment, income, economic growth and foreign relations or other objectives.

E-1(a). Special analysis will be given to Items 806 and 807 of the U.S. Tariff Schedules, the Mexican Industry Border Program, Foreign Trade Zones and the Generalized System of Preferences, with recommendations for review and revision by the Congress.

E-2. The Deputy Director for Import Review and Policy will conduct a special review and analysis of the General Agreement on Tariffs and Trade to discover absent signatories and their rationale; violations, compliance and/or noncompliance and the consequences thereof; the increase or decrease in voluntary restraint agreements, or orderly marketing agreements and the resulting effects; the efficiency of the dispute settlement procedures and their effectiveness; and gaps in the treaty that need to be bridged. Upon completion of the GATT Study, the Deputy Director for Import Review and Policy will report his findings to the Director and the Congress and make recommendations for the improvement and revision of the same.

E-3. The Deputy Director for Import Review and Policy, in close consultation with relevant offices of the Agency, will develop a National Import Policy Review System, with specific recommendations for integrating Import policy with the Economic and Social clause.

E-4. The Deputy Director for Import Review and Policy shall have the responsibility of administering the Antidumping Act of 1921, as amended, the Countervailing Duties provisions of the Tariff Act of 1930, as amended, and Sec. 201 of the Trade Act of 1974.

E-4(a) For the purpose of determining whether unfair trade practices or increased imports are a substantial cause of serious injury, or the threat thereof, to a domestic industry producing an article like or directly competitive with the imported article, the Deputy Director for Import Review and Policy shall appoint a panel of seven experts, including at least one trade union representative of the workers in the domestic industry concerned, and shall provide suitable staff assistance. The panel shall report its findings within 60 calendar days to the Director of the International Trade Agency (or, in exceptionally complicated cases, within 90 calendar days). The Director shall refer the findings to the Deputy Directors for the Labor Industrial Sector, Import Review and Policy, Intermediate and Small Business Assistance, Third and Fourth World Aid and Trade and the Multinational Corporation Monitor for their recommendations as to further action. Within 30 calendar days they shall report their proposals to the Director who shall rule on the matter.

F. The Deputy Director for Trade Negotiations, Agreements and Enforcement will be responsible for the Conduct of same.

(S)he will be second only to the Director of the International Trade Agency as the nation's chief trade negotiator, and will be accorded Ambassadorial rank.

F-1. Along with the Director, the Deputy Director or their designees will head each U.S. trade negotiation team, whether those negotiations concern bilateral, or multilateral agreements, are conducted with private or public entities, are exploratory or oversight in nature.

F-2. Along with the Director, the Deputy Director will select the members of each negotiating team. Members may be chosen from the private sector or the public sector, but each negotiating team will have two trade union members recommended by the Deputy Director for the Labor Industrial Sectors.

F-3. The Deputy Director for Trade Negotiations, Agreements and Enforcement will be held accountable to the objectives and principles of the Economic and Social clause.

F-3(a) Persistent and/or serious breach of the clause may lead to recall, replacement, or both.

F-4. The Deputy Director will be responsible for policing and enforcement of all U.S. trade agreements and the top investigative personnel of the U.S. Customs Service will be based in and function under the direction of this office.

G. It will be the duty of the Multinational Corporation Monitor to act as the Agency's Ambassador-At-Large to the transnational Corporate Community, both U.S. and foreign-based, which represents a new sovereignty in the world economy and world affairs.

G-1. The Multinational Corporation Monitor's primary duties will be to (a) keep the Agency and the public informed on the activities, behavior, policies and practices of multinational corporations in the world economic and trade arena (b) make aware and press upon multinational corporations their responsibilities toward fulfilling the objectives of this Act and the Economic and Social clause principles at home and abroad.

G-2. The Multinational Corporation Monitor will note the investment and marketing strategies, pricing policies and market shares of major multinational corporations in international trade.

G-3. The Monitor will analyze the control, structure, ownership, holdings and subsidaries of multinational corporations.

G-4. The Monitor will analyze intracorporate transfer pricing practices, with the aim of formulating accounting principles based on arms-length pricing.

G-4(a)The Monitor will propose suitable regulations and legislation to eliminate tax evasion and cross-subsidization of subsidiaries.

G-5. The Multinational Corporation Monitor will note the relationships of multinational corporations to cartels and other international business consortia.

G-6. The Monitor will note multinational corporation relationships with foreign governments, international agencies and foreign multinational entities.

G-6(a). In this conjunction, the Monitor will examine the activities, behavior, objectives and principles of the International Business Roundtable and other similar organization

G-7. The Monitor will make recommendations to correct multinational corporate abuses of power and will recommend ways for multinational corporations, both U.S. and foreign-based operating in the U.S., to comply with the principles and goals of the Economic and Social clause.

G-8. The Monitor will submit an annual report to the Director and the Congress which will be made public.

G-8(a)The Annual Report will include the findings and recommendations of the Labor Industrial Sector's office with respect to human and trade union rights and labor relations.

G-9. The Multinational Corporation Monitor will have subpoena powers for the purposes of fulfilling these duties.

H. The Deputy Director for Intermediate and Small Business Assistance will act as the Agency's chief liaison officer with the domestic business community.

H-1. The Deputy Director will work closely with the Export-Promotion and Policy office and Import Review and Policy office in order to assist small and medium-sized businesses in maximizing their share of world trade opportunities, consistent with the Economic and Social clause.

H-2. The Deputy Director for Intermediate and Small Business will give special attention to the Research and Development, Market survey and information, credit, financial and foreign currency; patent, and trademark, and licensing and permit needs of such businesses.

H-2(a)Priority consideration will be given to those firms and enterprises located in the Inner City Development Zones, rural areas and officially designated Labor Surplus Areas.

H-2(b) Additional priority will be given to those firms marketing new and socially useful technology, products and services.

The Deputy Director for Intermediate and Small Business, will cooperate and coordinate activities with the existing Small Business Administration, keeping intact the objectives and principles of the Economic and Social clause.

I. It will be the primary duty of the Deputy Director for Third and Fourth World (including the People's Republic of China) Aid and Trade to design and implement an economic development strategy that recognizes the existence of large and declining underdeveloped local or regional areas in the U.S. (1,092 Labor Surplus areas) and the basic human and economic needs of less developed nations.

I-1. Such a strategy will seek to develop the U.S. underdeveloped areas and declining industries, as well as foreign less developed countries by (a) making reciprocal trade, investment and aid agreements that will result in a net contribution to each country's balance of trade or current account and (b) reciprocally implement the principles and goals of the Economic and Social clause.

I-2. The strategy will focus on (a) agricultural development and food supply potential, development, or lack thereof, of (b) roads, rail, and water transportation and facilities, (c) community water sources and systems, (d) sewage and sanitation systems, (e) energy and electric systems, (f) communications systems, (g) capital goods requirements.

I-3. The Deputy Director, after determining the potential for development of a country's infrastructure, will prepare a prospective reciprocal trade, aid and investment package to be negotiated between the U.S. and the country. The development prospectus may be regionalized. It will honor the Economic and Social clause.

I-3(a) If a country agrees to negotiate a development program, the matter will be turned over to the Deputy Director for Negotiations, Agreements and Enforcement for conclusion.

I-4. All U.S. private negotiations and State or Local agency negotiations, and contracts with the People's Republic of China and Third and Fourth World governments and enterprises will be made through, in consultation with and the approval of the Office of the Deputy Director for Third and Fourth World Aid and Trade.

I-5. The Deputy Director for Third and Fourth World Aid and Trade will canvass and survey each of the U.S. underdeveloped areas, noting their assets and liabilities, in terms of human and natural resources, marketing, production and transportation characteristics.

I-6. The Deputy Director will actively recruit foreign direct investment in U.S. underdeveloped areas and prepare investment prospectuses for this purpose. Each prospectus will honor the Economic and Social clause.

J. The Deputy Director for East-West Trade will be responsible for developing and regulating exports to non-market economy countries with the exception of the People's Republic of China.

J-1. The Deputy Director will be the point of first contact for all U.S. private and governmental interests in East-West Trade relations.

J-1(a) The Deputy Director will be the conduit through which Soviet and Eastern trade initiatives will flow and will be an advisor to all such trade and aid negotiations.

J-1(b) The Deputy Director will analyze all trade and aid proposals in light of the objectives and purposes of this Act.

J-2. The Deputy Director will review and make recommendations with respect to most-favored nation status of non-market economy countries.

J-3. The Deputy Director will promote the Economic and Social clause principles in East-West trade relations.

J-4. The Deputy Director will annually canvass and survey sector-by-sector the condition and state of the non-market economies and report same to the Director and the Congress.

J-4(a) The canvass and survey will note and analyze trade and aid strategies, policies, and programs with respect to other countries and multinational corporations.

J-4(b) The report will be made available to the public in a timely manner.

J-5. The Deputy Director will assess the state of technology, industrial R & D, and the introduction of new technology in the Soviet and Eastern economies and report same to the Director and the Congress.

J-6. The Deputy Director will enforce the Export Administration Act with respect to non-market economy countries.

K. The Deputy Director for Tax Policy Review and Recommendations will analyze and assess the impact of current tax laws, regulations, exemptions and special tax treatments on U.S. trade, and current account balances.

K-1. A sector-by-sector approach, with firm and product specifics, will be taken. Focus will be on Deferred Taxes on Foreign Income, Tax havens, Intracorporate transfer pricing and transactions to avoid taxation, and identification of tax barriers and tax incentives to exports and imports.

K-2. The Deputy Director for Tax Policy Review and Recommendations will survey foreign tax policies and practices with respect to their international trade posture.

K-3(a). Focus will be on tax lures and incentives that attract foreign investment, particularly U.S. direct foreign investment. Special attention will be paid foreign trade-related investment performance requirements (local content requirements and export or import duties and tariffs).

K-3(b) Upon completion of the domestic and foreign tax impact studies, the Deputy Director will make recommendations for U.S. tax revisions that will enhance the objectives of this Act, and other proposals for dealing with trade-distorting investment performance requirements. Recommendations will be made to the Director and the Congress.

K-4. The Deputy Director will also prepare a proposal for International Conferences on Uniform Tax Policies and Fair Trade.

K-4(a) One Conference would focus on the industrialized nations.

K-4(b) A second Conference would focus on the Third and Fourth Worlds.

K-4(c) The purpose of the Conferences would be to (1) identify and ultimately eliminate unfair tax advantages and incentives in international trade (2) promote the concept of progressive taxation based on ability to pay among all nations.

L. The Deputy Director for Appeals and Grievances will chair a 5-member Board of Appeals and Grievances to hear complaints, that may be filed by U.S. private interests and individuals, U.S.-based multinational corporations, U.S. trade unions, and foreign governments and foreign-based multinational corporations, against agency rulings and decisions in an effort to resolve conflicts and disputes before they are taken to the Courts, presented for international arbitration and settlement, or become irreconcilable.

L-1 The members of the Board of Appeals and Grievances will be appointed by the Director of the Agency. At least two members of the Board will be trade union members, recommended by the Labor Industrial Sector Deputy.

L-2 The Board will hear and rule on Trade Adjustment Assistance appeals.

For the purposes of this Act, an Economic and Social clause may contain the following reciprocal agreements:

1. A commitment to economic planning for Full Employment and real economic growth.
2. A commitment to develop domestic markets and physical infrastructures.
3. A commitment to real per capita income gains for workers.
4. A commitment to redistribution of and social control over, concentrated land and wealth.
5. A commitment to annually devote a portion of the nation's wealth and income to a civilian Economic Development fund to be used indigenously for job creation and worker training
6. A commitment to eradicate starvation, malnutrition, hunger, disease, illiteracy, ethnic, racial, religious and sex discrimination, and child forced prison and slave labor.
7. A commitment to water and air pollution control and environmental protection standards.
8. A commitment to develop safe, renewable, non-nuclear low cost energy systems and a commitment to nuclear nonproliferation.
9. A commitment to access to media by the public, trade unions and democratic opposition political parties.
10. The absolute right of freedom of association for workers; the guaranteed right of workers to organize and form free and independent trade unions for purposes of collective bargaining with employers — private, government or any combination thereof — over the terms of their wages and compensation, hours, safety

and health and other working conditions; the inviolable right to use the strike as an economic weapon in the collective bargaining process.

11. The right of workers and their trade union representatives to help formulate, promulgate, implement and police the economic and social clause in their respective places of work, firms, industries and at all government levels.

12. The right of workers and their trade union representatives to have access to enterprise and government data and information relevant to costs, pricing policies, including the right of workers and trade unions to participate in planning and decisions for expansions, transfers, nationalizations, redundancies, and the introduction and deployment of new and labor saving technology.

13. The right of workers and trade unions to participate in the political processes, form political parties and/or make political alliances and coalitions and the right of trade unionists to seek public office.

(14) Where an international aid, trade, or investment agreement involves military goods and services, a 10% surtax will be * levied on the vendor's after-tax profits and paid into the United Nations Peace Keeping Mission.

Rebuilding America

Domestic Economic and Industrial Policy

It is the purpose of this title to promote full employment and economic growth by: (1) legally defining large corporations as entities with economic and social responsibilities to the communities in which they operate and to the nation as a whole; (2) providing for coordinated domestic economic planning; (3) protecting workers and communities against sudden plant closures, transfers and mass lay-offs.

A. Private corporations doing business in interstate commerce are deemed to be operating for the convenience and needs of the community, in the public interest for the benefit of the public and in expectation of benefit to the public, and will be federally chartered.

A-1 Application for charter will be made to the Secretary of Commerce, who will issue federal coporate charters and establish the fees and procedures for same.

A-1(a) Each federal charter will include an economic and social clause that will commit the corporation to (1) guaranteed human rights in its employment policies and practices and its corporate conduct in the community (2) guarantee its employees the right to organize and bargain collectively for wages, hours, working conditions, etc. (3) protect workers and communities from environmental, health and safety hazards (4) provide one year's advance notice to the Secretary, the community and to its workers in event it finds it necessary to shutdown, close, move, transfer or otherwise curb or curtail all or part of its operations, such necessity to be proven at a public show cause hearing, if challenged by the workers and/or their bargaining agent, and/or by community petition (5) annually pay an amount equal to 1% of net sales into a federal investment reserve fund.

B. The Domestic Investment and Production Agency is created.

B-1 The Agency will have exclusive responsibility within the Executive Branch for domestic economic policy formulation and implementation. It will have the primary duty to develop an industrial policy that will achieve and sustain full employment, mitigate economic dislocation, allocate resources and facilitate the transfer of resources to designated areas of priority need and critical and emergency needs.

B-2 The Agency will have a Director, nominated and appointed by the President with the advice and consent of the Senate.

B-3 The Director will serve at the will and pleasure of the President, be granted Cabinet level status, with salary and perks commensurate.

B-4 The Agency will have the following offices, each headed by a Deputy Director, nominated and appointed by the President, with the advice and consent of the Senate:

Congressional Liaison and Interagency Cooperation
National Priorities
Foreign Trade Agency Coordinator
State, Regional and Urban Development
Rural Development and Land Use
Research, Development, New Products and Marketing
Capital Formation and Mobility

B-5 Each Deputy Director will report directly to the Director and be given status, salary and perks commensurate with the Deputy Secretary level.

B-6 The duties of the Congressional Liaison and Interagency Cooperation Deputy Director are apparent on their face and (s)he will (a) keep the Congress fully informed of the activities, programs, problems, and progress of the Agency and its offices (b) keep the Director and Deputy Directors informed of Congressional actions and sentiments with respect to legislation and policy formulation (c) maintain liaison with all other departments and agencies of the federal executive (d) develop and prepare each year a legislative agenda for the President to present to Congress.

B-7 The Deputy Director for National Priorities will have the following duties: (a) through social cost-benefit analysis, review and evaluate all federal assistance, regulatory and tax programs affecting economic development, in order to identify overlaps and/or gaps, excessive bureaucratic costs, and tax barriers or bonanzas (b) canvass and prioritize economic and social needs in the civilian sector of the economy (c) independently review, assess, prioritize and make recommendations to reconcile the economic demands of the military sector of the economy, with the needs of the civilian sector (d) develop an economic adjustment and development plan that will (1) fulfill unmet civilian economic and social needs, (2) meet realistic requirements of the military (3) in the event of economic dislocation, whenever and for whatever reason, protect workers income, health care and housing; provide job training and continuity of employment; sustain vital community services that may be impaired and develop an economic reconstruction plan that will make impacted local economies viable and whole.

B-7(a) The National Priorities Deputy Director will have discretionary use of the federal investment reserve fund A-1(a)(5) for the purpose of B-7(d)[redacted] above

B-7(b) The National Priorities Deputy Director will, upon notice from the Secretary of Commerce that a federally chartered corporation's advance notification of intent to close has been challenged, by either the workers or community, appoint a five-member public commission to hold public hearings in the local community, where it will be incumbent upon the corporation to show cause why it cannot continue to operate profitably for the convenience and needs of the community.

B-7b (1)The Commission will have subpoena powers to produce witnesses, corporate data and information.

B-7b (2)Corporate data and information will be shared with petitioners.

B-7b (3)Petitioners may call for expert witnesses and testimony.

B-7b (4)If the Commission finds the corporation failed to show cause, a permanent injunction will be issued to prevent the corporate shutdown, move or transfer.

B-7b (5)Quick-sale successors, whether intrastate or interstate or foreign, will be bound by the economic and social clause of the original federal charter.

B-7b (6)The corporation may appeal the Commission's finding to the federal courts, and petitioners may also appeal.

B-7b (7)If the corporation violates a permanent injunction, the National Priorities Deputy Director will recommend to the Director federal seizure and operation of the facility or business.

B-7c In cases of failing enterprises or enterprises faced with extinction, the Deputy Director will have the duty and power to recommend to the Director a plan for either (a) public ownership including, community/worker ownership, or nationalization (b) taxpayer subsidies, or their elimination, or government-private joint ventures (c) taxpayer loans or loan guarantees (d) acquisition or merger (e) consolidation (f) divestiture (g) bankruptcy (h) liquidation - all consistent with the economic and social clause.

B-7c (1) The public hearing Commissioners will be selected from the American Arbiters Association and none may have a direct or indirect pecuniary or vested interest in the corporation.

B-7c (2) They will be paid per diem expenses while hearing the case, plus a reasonable fee while coming to their decision, which will be written, with majority and minority opinions.

B-7c (3) All records and transcripts of the proceedings and decision will be made public and become the property of the federal government kept in trust for the people.

B-7d Costs of the show cause hearings will be borne by the Agency.

B-8 The Deputy Director for National Priorities will recommend ways to achieve uniform federal labor laws and standards consistent with the highest denominator of the economic and social plan recommended by the Labor Industrial Sector Board of the International Trade Agency, as prescribed in the Inner Cities Act's development zone and as required in the federal corporate chartering procedure in A above.

B-9 Whenever inflationary prices persist for six months or more in industries characterized by monopoly or oligopoly, or by other non-competitive forces, or in industries supplying the basic necessities of life, i.e., energy and utilities, food, housing, health care and transportation, the Deputy Director for National Priorities will investigate and analyze the causes of those inflationary prices, and will develop a targeted economic controls program for such industry or industries, and recommend to the Director that the President invoke economic control powers that may be granted by the Congress, or in the absence of Congressional sanction, recommend the President request such authority, and upon Congressional assent and Presidential directive, the Deputy will implement the program.

B-9a The Deputy will have subpoena powers for the purposes of conducting the investigation.

B-9b Any cost and price monitoring staff necessary to the investigation and analysis and/or necessary to carry-out the controls program, will include at least two trade union members recommended by the Deputy Director of the Labor Industrial Sector Board of the International Trade Agency.

B-9b(1)To the maximum extent possible, all other staff for the Economic controls program will be recruited and borrowed from among career civil service employees already in the federal service.

B-9b(2)Failure to cooperate in the cost and price analysis and investigation, or failure to comply with controls may lead to federal seizure of corporate assets, management and operation by the Agency, or heavy fine levied on offending corporate directors and executives , or all of the above.

C 3 The Foreign Trade Agency Coordinator will work closely and in consultation with the Labor Industrial Sector Board of the International Trade Agency.

C-1 The Foreign Trade Agency Coordinator will have access to and convey all studies, data and information produced by that Agency, to the Domestic Investment and Production Agency, which will utilize the Labor Industrial Sector Board as its primary industrial sector research and fact-finding arm.

C-2 The Foreign Trade Agency Coordinator will work in consultation and harmony with all other offices of the International Trade Agency as circumstances may require and dictate.

D 4. The Deputy Director for State, Regional and Urban Development, will have the following duties: (a) establish and maintain liaison with all state, regional and urban industrial development and planning agencies (b) canvass and survey state, regional and urban industrial development plans, comparing incentives and differentials in taxes, wages, land and building costs, labor laws, safety and health and environmental protection laws and regulations (c) canvass and survey sector-by-sector the condition and status of state, regional and urban economies, noting strengths and weaknesses of the industrial base and forecasts for growth or decline (d) prioritize and synchronize state, regional and urban development goals (e) design industrial development programs that will match needs and resources, facilitate the mobility of resources to underdeveloped areas, and which will eliminate artificial economic and social differentials that are used inefficiently and unfairly as industrial development lures and which have socially undesirable consequences.

D-1 Each program will be consistent with the economic and social clause in A above.

D-2 The Deputy Director for State, Regional and Urban Development will work closely with the Foreign Trade Coordinator in matching resources and needs for industrial development.

E 5. The Deputy Director for Rural Development and Land Use will have the primary responsibility to develop a long range domestic food and fiber policy.

E-1 Duties will include: (a) canvass and survey the economic and social conditions of the rural population on the farms, in the communities, among the Native American nations and migrant labor (b) inventory rural land use and values (c) survey farm production land ownership and control, with income, size and value classifications, and historical trends and projections (d) assess and forecast food and fiber producers' resource needs, on a commodity-by-commodity basis, and compare with domestic needs for food and fiber and export potential (e) prepare and prioritize a rural community needs agenda and develop a business and industrial program, consistent with the economic and social principles in A above, with emphasis on community physical infrastructures (f) prepare and prioritize a farm-to-market production program that will meet domestic food and fiber needs forecasts and synchronize domestic policy with a realistic food and fiber export policy. Such a program may recommend restructuring of the production and distribution system in terms of efficient resource allocation, ownership and control (g) investigate, study and recommend ways to alleviate labor surplus and labor abuses in rural areas.

E-2 The Deputy Director for Land Use and Rural Development will coordinate and work in cooperation with the Chair of the Food and Fiber Production and Processing Committee of the Labor Industrial Sector Board of the International Trade Agency.

E-3 6. The Deputy Director for New Technology, Research and Development, and New Products will have the primary duty to investigate, study and recommend programs to: (a) monitor the advent and introduction of labor-saving new technology (b) move displaced labor resources upstream in the manufacture, deployment, operation and maintenance of the new technology, before it comes on line (c) train and retrain workers displaced by new technology for employment in areas and occupations where skills and workers are in short supply. In this connection, the

Deputy Director will utilize the new technology in the design of a national employment opportunity service, that will have the capability to move into a local plant and job site and match up redundant job skills with job opportunities throughout the country (d) share productivity and cost-savings with workers impacted by the deployment of new labor-saving technology (e) develop a code of conduct to protect workers' privacy in the workplace and to prevent employers from using the new technology unscrupulously (f) prevent a corporation from gaining monopoly or monopsony market power through new technology (g) seek and find new ways to absorb new technology into job creating and socially-useful production through new markets and new products (h) prepare and prioritize a list of research and development projects that would fulfill or help fulfill unmet and critical national needs, such as energy conversion to safe, renewable energy sources and systems; mass transit; rail revitalization and rehabilitation; inner city and rural infrastructure rehab; seaport and harbor facilities; water transportation; and fuel efficient vehicular transportation.

F 7. The Deputy Director for Capital Formation and Mobility will have the primary duty to establish and organize a National Industrial Development Bank. (S)he will be the Director of the Bank.

F-1 The Bank will serve as the primary financial institution for the International Trade Agency and the Domestic Investment and Production Agency. Initial funds for the Bank will come from: (a) a graduated progressive surtax on defense contractor and subcontractor profits and foreign military sales profits as long as such profit controls are in suspension (b) such sums appropriated by the Congress as may be necessary to carry out the provisions of this Act (c) one-half or any greater unused portion of the federal investment reserve fund (A-1)(a)(5).

F-2 The Bank Director may:
(a)establish regional, state and local banks (b) may establish industrial sector banks (c) the Bank may issue federally guaranteed bonds to raise capital (d) the Bank may sell federally guaranteed certificates of deposit, to cooperative banks and institutions, to private and public pension funds, to individuals in small and large denominations (e) the Bank may receive and keep on deposit at competitive interest bearing rates, surplus funds of state and local governments, their agencies and subdivisions (f) the Bank may lend money on approved payback schedules to private entrepreneurs, small and medium private businesses and/or consortia thereof, federal enterprises, government-private joint ventures, consumer and producer cooperatives, community and/or worker-owned enterprises, local, state or regional industrial development agencies and projects, Native American nations, and foreign-based firms investing in the domestic economy (g) each borrower will agree to abide by an economic and social plan, to be negotiated at the time of loan, and which will at a minimum guarantee (1) job creation and/or additional employment (2) compliance with federal fair labor standards (3) human rights in employment policies and practices (4) the right of workers to organize and bargain collectively (5) job safety and health protections (6) community environmental protections (7) safeguards against mass lay-offs due to new technology, shutdowns, moves, or transfers of production.

F-3 There will be duly elected Local Community and worker representatives on any boards of financial agencies created under this Act.

F-4 Bank loans will be made on the basis of meeting the priorities determined by the Labor Industrial Sector Board and Export Promotion Office of the International Trade Agency, the National Priorities Office, Land Use and Rural Development Office, and State, Regional and Urban Development Office of the Domestic Investment and Production Agency.

G The exclusive power of the states to issue corporate charters to firms and business entities operating in interstate commerce is rescinded upon adoption of this Act, except that a state may require its own charter in addition to the federal charter, if the standards and requirements contained in the state charter, are equal to or exceed those contained in the economic and social clause of the federal charter.

Senator WEICKER. Senator Hayakawa has a statement I believe.

Senator HAYAKAWA. I do indeed.

Senator WEICKER. I am very anxious to hear it. I hope it is in no way a criticism of the chairman or anything that might be embarrassing.

Senator HAYAKAWA. I may disagree with you, but I never criticize you. [Laughter.]

STATEMENT OF HON. S. I. HAYAKAWA, A U.S. SENATOR FROM THE STATE OF CALIFORNIA

Senator HAYAKAWA. Mr. Chairman, as is everyone else in this room, I am deeply concerned about the effects of continued high interest rates and their effect on the economy, especially on small business.

I cannot go back to San Francisco, Los Angeles, or San Jose without people bending my ear on the subject—in all sorts of places.

Some of them say: Under present interest rates, I think I can last 6 more months. Some say: I think I can last 9 months. Others say: I can only last 3 months. And so on.

Business failures are up a shocking 42 percent over the last year and more are expected to go under before the economy improves.

I regret I was unable to attend the hearing yesterday. I understand from both the written testimony and the reports I was given that the interests of small businessmen were ably defended by my fellow committee members.

I do not wish to take up a lot of time this morning, but I feel a need after yesterday's spirited discussion to express my views on the subject.

I too believe that the interest rates are too high. They are killing off businesses which have provided valuable services to their communities for many years.

However, just as strongly as I believe the interest rates are having a devastating effect on business, I believe the interest rates are not a cause but a symptom of a far worse problem. That problem is inflation.

Where persistently high interest rates ruin businesses and even industires, inflation ruins societies.

This is an obvious example, but after World War I Germany tried to pay its debts by merely printing money. The result was an inflation that drove the country to disaster. Mothers toting knapsacks full of deutsche marks could only buy a half a loaf with their life savings. Soon no one cared about culture, society, and eventually not much about life either.

Normal citizens became hedonists and finally they became eagerly susceptible to the rhetoric of facism and the dehumanizing of a whole people.

I believe it is incumbent on us to prevent that kind of voracious inflation from destroying our American way of life.

While it may be expedient to want relief from the symptom—high interest rates, I think we need to concentrate on the fundamental disease which is inflation itself.

If we try to abate the tight money policy that is creating the atmosphere for high interest rates, we will lose the fight against inflation. Interest rates will fall, for a short time; however, when the resulting inflation begins its powerful upsurge, it will take interest rates higher than we have ever imagined.

On the other hand, if we tackle the central problem of inflation, interest rates will drop to a manageable level.

If we start with the definition of inflation as too many dollars chasing too few goods, it is apparent that attacking the problem can be done at either or both ends. That is, the number of dollars should be reduced or the number of goods should be increased.

The administration's economic policy pursues both goals by restricting the growth of the money supply and providing incentives for industries to increase their productivity.

Restricting monetary growth is, therefore, absolutely essential to combating inflation. Without monetary discipline, the supply of money will increase beyond the increase in productivity. Thus, inflation will continue.

I am aware of the hardships that tight money policy is creating for borrowers. However, the resulting high interest rates reflect the closing margin between real growth and monetary growth.

When capital is infused into the market from nonartificial sources—from, for example, reductions in taxes—demand for credit will ease and interest rates will fall.

Both of these depend on the success of our attack on the other side of the inflation equation—namely, providing incentives for the growth of productivity.

The tax bill that we recently passed is a crucial element of the program for economic recovery and cannot be deferred or tied to deficit levels.

For the first time in 50 years, there is an opportunity for Americans to catch up with Government spending by retaining some of their earnings.

Both personal tax rate reductions and the accelerated cost recovery system will create a pool of capital from which businesses may draw for the growth of productivity.

Without this capital, there can be no expansion; and we will continue to experience unemployment and economic stagnation.

The other element of the President's program, Mr. Chairman, which others have emphasized more than I, is the budget cuts necessary to keep our deficit from interfering in the credit market further than Government already has.

Federal spending has been encroaching upon private investment and productive resources to the extent that capital is either not available to producers or it carries too expensive a price tag.

I agree with Mr. Schultz that the deficit must be reduced, but I do not agree that it can be done either by raising taxes or by cutting the budget. It is not a matter of alternatives. It must be accomplished by budget reductions.

Taxes have finally been lowered to give investors and producers a long-range view of new capital resources. We must not disrupt that expectation.

In conclusion, I want to emphasize that inflation is the problem we must concentrate on first. As a result of the tax and budget legislation which we have passed, if we maintain our confidence and our determination, both inflation and excessive interest rates will fall.

We have to hang tough. If we fail by giving in to pressures about interest rates, the entire program and thus the entire economy will be in jeopardy.

Thank you, Mr. Chairman.

Senator **Weicker**. Thank you, Senator Hayakawa, I appreciate your comments. I think it is a well-balanced presentation of another point of view on the issue and a valid one.

Our next witnesses will consist of a panel. We have Mr. Frederick Napolitano, president-elect of the National Association of Home Builders; Mr. Clem Watson of Custom-Built Homes, Norwich, Conn.; and Mr. Craig Meyer of the Home Builders Association of Savannah, Ga.

Gentlemen, it is nice to have you here. Please go ahead and make your presentations in any order that you choose.

STATEMENT OF FREDERICK J. NAPOLITANO, PRESIDENT-ELECT, NATIONAL ASSOCIATION OF HOME BUILDERS, VIRGINIA BEACH, VA.

Mr. **Napolitano**. Thank you, Mr. Chairman.

My name is Frederick J. Napolitano, and I am a homebuilder from Virginia Beach, Va.

I am testifying today on behalf of the more than 123,000 members of the National Association of Home Builders, of which I am president-elect.

Joining me at the witness table today are two fellow homebuilders—Clem Watson from Norwich, Conn., and Craig Meyer, president of the Savannah, Ga., Home Builders Association.

Mr. Chairman, I intend to summarize my statement this morning and request that my full statement be printed in the record.

Senator **Weicker**. It will be included in the record in its entirety at the completion of your oral presentation.

Mr. **Napolitano**. I will attempt to give you an overview of what is happening in our industry and the small business people who represent our industry. The gentlemen with me will give you some of what we refer to as the "horror" stories that are occurring.

We are deeply appreciative to the chairman and the committee for scheduling these timely hearings on the devastating impact of high interest rates on small businesses.

Mr. Chairman, your committee has given us a forum to express our views since November of 1979 when we warned that the actions of the Federal Reserve Board on October 6, 1979, could lead to a catastrophic collapse of the housing industry with its attendant loss of jobs, Federal revenue, and devastating impact on the homebuying public.

I do not think that we exaggerated the impact. In fact, if we had followed some of the economic prescriptions recommended by this committee and its chairman over the last 2 years, I do not think I would be appearing before you today with such a dismal short-term economic outlook for housing.

What is the current state of the housing industry? Mr. Chairman, one of the largest and most important small business industries in America is virtually out of business.

New housing production for August was at a seasonally adjusted annual rate of 937,000 units—the lowest monthly rate since February 1975.

Our projections indicate that housing production for 1981 may end up at only about 1.07 million units—the lowest year since 1946. Unless interest rates decline sharply, 1982 production levels will not improve very much.

What about jobs? According to Government statistics, 863,000 wage and salary workers in construction are unemployed. Add to this figure about 200,000 more who are self-employed.

The unemployment rate of 16.7 percent—more than double the overall rate of unemployment—will likely increase to 21 percent by the end of the year and will go higher in early 1982.

A mere 2 percent of builders report that sales are good to excellent. That compares to 70 or 80 percent in a good year.

Traffic at subdivisions is almost nonexistent. Fewer than 7 percent of builders report traffic to be good to excellent. That compares to 40 or 50 percent in a good year.

The failure rate among construction firms is up 41 percent for the period of January to August 1981 as compared to the same period in 1980. Failure rate among subcontractors is up by 120 percent.

Mortgage money generally is not available. What is being offered is at record rates. Freddie Mac yields are over 19 percent in mid-September.

In short, housing activity has come to a standstill across the country in the face of persistent high interest rates. Our Nation's homebuilders are fighting for survival against mounting odds.

What is the economic impact of all this? From the beginning of the slump in 1978 until today, we estimate that this housing downturn has cost the American economy more than 2.8 million man-years of employment, $49.2 billion in wages, and $15.7 billion in total tax revenues. The total overall economic impact has been $223 billion.

Most significant for this committee, I believe that we will see a major shift away from the "small business" character of this industry when the market is revived. Business failures are up by 41 percent over last year, and the smallest and least-capitalized firms are the ones which are most likely to go under. The net result will be fewer and larger building firms.

Mr. Chairman, what would be a real tragedy is that this industry could lose one of its basic strengths if we lose our base of smaller, fiercely independent and competitive builders.

What can I say regarding the home buying and renting public? We have emphasized repeatedly in our appearances before this committee the record demand for housing during this decade. Projections indicate that in the 1980's some 41 million people will reach the home buying age of 30. This compares with about 31 million who reached that age during the 1970's.

The rate of new household formations will be 25 percent higher in the 1980's than during the last decade.

All I can add is that with housing production at about the 1 million level for the past 2 years, which is the first 2 years of the decade, we will fall even further behind in meeting the overall demand.

I believe that unless this demand is met, there will be a revolution. That revolution will take place at the polls in 1982 and 1984.

What is today's reality? Unfortunately, the numbers on affordability tell us the sad story—simply but very graphically.

A modest $60,000 mortgage loan at 9-percent interest—the going rate 2 years ago—required a monthly payment of $483. At 17.5 percent, the payment is $880 per month—almost double the payment of 2 years ago.

In order to meet these monthly payments, a family would need an annual income of almost $40,000. Only 18 percent of the American people have an income high enough to afford that home. Virtually no first-time home buyers would qualify for a home at those interest rates.

In order to focus national attention on the impact of high interest rates on the credit-sensitive industries, we have embarked on what we call an "Unlock the Economy" campaign which was developed at our NAHB board of directors meeting earlier this month.

We have joined in a coalition with the National Association of Realtors and the National Automobile Dealers Association, who I believe are appearing before you today.

There are three basic elements to this program to combat the high interest rates.

First, we call upon the administration and Congress to meet the initial administration targets of less than $42.5 billion deficit in fiscal 1982 and a balanced budget by fiscal 1984.

We recognize that this will require substantial reductions in defense expenditures and additional cuts in nondefense expenditures, as well as reductions in entitlement programs. It may even involve deferral of the individual income tax reductions already approved by Congress.

Second, we then call upon the Federal Reserve Board to institute policies that will allow the money supply to grow at the upper end of the Fed ranges and at a rate that will accommodate economic growth and stability. In this effort, we seek the support of the President and the Congress for this change in Fed policy.

Third, we seek to broaden the representation on the Fed Board of Governors to include representatives from the credit-sensitive small business sector of the economy. We would support the appointment of a small business person to the Fed when the term of Vice Chairman Schultz ends early next year.

Regarding issues which specifically affect housing, we believe that there are a number of areas which would have a positive short-term and long-term impact.

First, we strongly believe that immediate action must be taken to make the tax-exempt housing bond program workable through passage of technical correction legislation sponsored by Senator Jim Sasser and Senator Howard Baker, known as S. 1348.

In addition, Treasury should redraft and simplify the complex regulations issued for the single-family program. Treasury should also expeditiously issue the regulations implementing the multifamily program.

Second, we have drafted legislation to encourage increased pension investment in mortgages by eliminating the so-called prohibited transaction provision in the ERISA law and by recognizing investment in residential mortgages as a prudent investment.

Mr. Chairman, I cannot in good conscience say that enactment of this program would lead to a healthy economy and a robust housing industry in the next 3 to 6 months. Because of the imminent danger of bankruptcy to many builders over that period of time, I am not optimistic about the short-term outlook. However, such a program would give a signal to the Fed, Wall Street, the housing consumer, and the homebuilder that we have begun to turn a corner and that if we can just hang on a little longer, economic conditions will improve.

When speaking to the White House just recently, they said: Keep your eye on the big picture. That is fine, but the analogy is that we may have a great corn field developing and we are going to have the best crop we have ever had 6 months or a year down the road, but if I am not alive to enjoy that and I am dying right now, I cannot appreciate that too much. That is what is happening to the people in our industry.

As I assume the leadership of the NAHB in January, I would like to be able to give our members and the home buying and renting public just that message—that we are going to start turning this thing around.

Mr. Chairman, I hope that we can continue to work together to achieve that goal.

At this time, I am pleased again to introduce my fellow builders. I would like Clem Watson from Norwich, Conn., who has been a very successful single-family builder for many years, to speak next.

Then next is Craig Meyer who is president of the Savannah Home Builders Association.

Senator WEICKER. Mr. Watson?

STATEMENT OF CLEM WATSON, CUSTOM-BUILT HOMES, NORWICH, CONN.

Mr. WATSON. My name is Clem Watson. I am from Franklin, Conn. I have been building single-family houses for approximately 25 years.

I am very proud of Mr. Weicker because he tells it the way it is, but I am not proud to be here. I am not proud of the fact that in the next 6 months I may be bankrupt and out of business.

I stopped into a bank the other day and asked for some mortgages. I was quoted 18 percent and told to take a vacation and bite the bullet.

I cannot speak for all of Connecticut, but I can speak for eastern Connecticut. We have over 200 builders in that area who build from one to five houses a year. Those builders are out of business. They have one or two houses sitting which are not selling. They have no incomes. Lumber yards are folding up in our area.

We have had CHFA mortgages which some Government institution has put out of business because it was helping local people to obtain housing. That program at least kept local builders and real estate agents in business and gave people housing.

Short-term financing is 24 percent. Nobody can stay in business and pay those kinds of rates.

It is true that the builders have a plight. However, as I say, there are approximately 200 of us in eastern Connecticut, which is not very much.

Let us talk about the people in eastern Connecticut. We have the Navy in Groton, Conn. How would you like to be a sailor out at sea 3 months under the water and not know where your family is going to live and not know whether your children have a decent house or a decent apartment which is not run down?

How about the workers? They should have houses; they should have places to live. It is not a matter of having an individual single family house; it is a matter of having a decent place to live and a decent roof over your head.

People I built houses for in 1964 and 1965 today send their children to me to build them a house. I have to tell them: I am sorry; I cannot do anything for you.

The average wage in our area is $6 to $8 per hour. Multiply that out. It is $12,000 to $15,000 a year. It costs $25,000 to $30,000 per year to afford a home which I build for $45,000—and that is an inexpensive home.

We are talking about flesh and blood. We are talking about people.

This country fought many years ago for its independence, and maybe it is time that we fight for our independence again. I believe that unless this administration reduces interest rates so that people can live, we might as well all come down to Washington and straighten it out.

Thank you, Mr. Chairman.

Senator **Weicker**. Thank you very much, Clem. I could not agree with you more.

I think you phrase it very personally and hit the nail on the head.

This homeowning business is not a matter for a few rich people. The day it becomes a matter for a few rich people, believe me, we are going to have big problems in this country.

The fact is that homeowning was within the reach of every American—moderate-income Americans. Even those of low income had a decent roof over their heads in the rental category.

When I see what is happening in our own State of Connecticut—as you say, in eastern Connecticut but indeed throughout—believe me, I fear for what the impact is going to be.

I did not mean to interrupt, because I am going to have some questions later.

I know Mr. Meyer is here and would like to proceed. Go right ahead.

STATEMENT OF E. CRAIG MEYER, PRESIDENT, HOMEBUILDERS ASSOCIATION, SAVANNAH, GA.

Mr. **Meyer**. Thank you, Senator. It is a pleasure to be here.

My name is Craig Meyer. I am a home builder in the Savannah, Ga., area. It is a position I have enjoyed for the last 6 years.

I am 34 years of age, college-educated, married, and I have a 13-year-old daughter.

My early training prior to homebuilding was in economics and banking. I was privileged to be at one time the youngest assistant vice president of the Trust Co. of Georgia system. However, I departed that monthly salary for the homebuilding industry.

I was convinced at that time that the housing market would steadily improve and that Government and the financial community now had both the experience and the tools to avoid the type of disaster that occurred in the mid-1970's when I made that decision.

In my community, a city of approximately 200,000, I am currently serving as president of the Savannah Home Builders Association. I am a member of the Salvation Army Advisory Board, a past participant and the current program chairman of the leadership Savannah program, and have served as vice president of both the Society of Real Estate Appraisers and the Mortgage Bankers Association of Savannah. I serve on various boards and committees in the private and governmental sectors, and I am frequently consulted by our city fathers on matters of a political nature and building codes.

My wife serves as vice president of the Savannah Ballet, which is one of the two recognized ballet companies in Georgia, and is active in many other civic and cultural affairs within our town.

I am not telling you this to blow my horn. I have accomplished this, and I am sitting here as an integral part of the Savannah community.

With all of this, I now have one very serious problem. That is that I cannot presently pay my bills. I have no income. This situation has existed for approximately 90 days.

I cannot pay my taxes. Worst of all, I cannot pay my interest to my banks, which is running at voluminous rates. I am presently existing on my wife's income and money borrowed from family members while the expenses of my business continue to mount.

Ironically, though, I consider myself fortunate in relation to many of my counterparts who do not have the blessings of my minimal resources. You see, I am not broke yet. I have inventory in completed homes and developed lots valued at $443,000, against a debt of approximately $250,000. I no longer have any cash within my company.

High interest rates have forced home buyers from the market, both financially and psychologically. Unless buyers have company subsidies from their corporations or cash, they are not in a mood to even look at housing regardless of their financial capacity.

We are presently making some deals with some prospects who will rent our homes until the interest rates may return to a level at which they may qualify. This has the potential of saving me some interest money, perhaps as much as 80 percent. However, these rents do not come close to covering prime rates we are being charged—at the level of 20 percent.

Add to that the taxes and insurance which we must pay on our standing inventory, and it results in a negative cash flow of drastic proportions.

During the past 120 days, the builder membership of our local homebuilders association has fallen by over 10 percent. I can readily identify another 20 percent, including myself, that might fold within the next 90 days without an immediate change in interest rates.

Is this equitable to small business in relation to the major corporations?

I will depart from my speech for just a moment to show you the business page of the Atlanta Journal yesterday which reflected for the major banking institutions in the State of Georgia an average net increase of earnings in the first 6 months of this year in relation to that same period of time last year—an average increase of 25 percent over last year.

The banks advise me that their cost of money is so high, yet their earnings are turning like this.

National trends indicate only a drop of 11 percent in the starts for new housing. At least those are the figures reported by the Commerce Department. Let me assure you that the starts rate in Savannah, where we have a relatively level economy which is not predicated on any one type of industry, is down at least 50 percent. Builders are not starting new homes. We have no profits available to us. With cash flow at a standstill, there is only so much available in retained earnings in our companies to forestall impending disaster.

A survey that we performed in the standing inventory of our local builders last Monday indicated that we had 141 homes available in the Savannah market. This compared favorably to the same period in 1979 when we had approximately 350.

The question is, Where will people live if and when we do return to any normal type of situation?

Borrowing or refinancing against present inventory is now out of the question, as our bankers view our industry with bad taste. This bad taste was generated, of course, from the 1974 to 1975 debacle which hurt many of them so badly and even forced seizure by the comptroller and the Fed of several banks.

Just this week, my banker who is also one of my close personal friends, looked across his desk at me and sympathetically said:

> I understand your problems, Craig, but we just don't see any improvements in rates until next summer. You and I both know that you can't hold on that long. We are afraid of throwing good money after bad.

Gentlemen, if his prediction is correct, then so is his analysis; because I cannot hold on until next summer and neither can 60 percent of my counterparts nor half of our supply houses that supply us materials and not many of our plumbers, electricians, carpenters, or realtors.

I recently calculated that it takes approximately 90 days to construct one of my standard homes during which time I place orders from a minimum of 15 suppliers and pay a minimum of 59 workers who have a part in assembling all of the various components of building materials into a home.

I have not begun a new home in 4 months, so all of those men have had their potential work diminished with no visible work to replace that loss.

My cement finishers are now broke; my plumber has laid off all but one of his helpers; my framer is looking for work in one of the local manufacturing plants with no success; and my painter has not paid the paint store in 60 days and is cut off.

If this trend continues, there will not be qualified labor nor craftsmen to build the homes needed to house the greatest growth in family formation in our history, as the demographers tell us.

The old law of supply and demand tells us that when we have a low supply, prices are forced upward. In Savannah, we currently have less than one-half of the inventory of 1979.

Where is the justification then that tight money will decrease inflation in housing? This reasoning defies all logic.

In summarizing the effects of high interest rates in Savannah and other towns similar to ours across this wide country, I would like to say that builders, suppliers, realtors, subcontractors, and laborers are being forced out of business or into bankruptcy or other fields of employment.

Rents are rising rapidly in the face of tight occupancy levels where rentals are available. Senator Nunn's secretary advised me this morning of a $150 monthly increase on her apartment.

The supply of new housing is dwindling, which will create severe inflation in housing when and if a reasonable rate returns.

On behalf of our homebuilders and Americans in need of housing, it has been my pleasure to appear before you. I hope I do not have to again and hope that working together we will find a solution, because I do not have that solution. Thank you.

Senator WEICKER. Fred, are you telling the administration what your feelings are on these matters?

Let us go over the ground very carefully; I have no quarrel with this at all.

You and many small business groups around this country clearly backed the President and clearly backed the President's economic program.

Some people spoke rather skeptically of it to various degrees, but there is no question about the fact that the small business community, of which you are a representative, certainly have been important supporters of the President, both in election terms and in terms of his initial economic plan.

Like anything else, I do not think it would be fair to expect of the President that anyone's plan is going to be 100-percent perfect. I am not so sure that is not the mindset of the President and his advisers—that if we do not get 100 percent, it somehow reflects on our inadequacy. I do not think that is the case. I think a lot of times a few minds are much better than one.

Are you getting through to the President as to what you feel—you have set it down in your statement, and I like your statement—needs to be done in refining the economic program?

Mr. **Napolitano.** Yes, Mr. Chairman.

To answer your question specifically, the answer is yes; however, let me back up and give you a little bit of history.

Last year when the elections were taking place we had, the same as anybody else, Democrats and Republicans and Independents. Our people were looking for a change in direction and a change in philosophy. They thought that this administration provided that change. That is why this President was elected and this administration was elected, in our opinion.

Senator **Weicker.** No argument.

Mr. **Napolitano.** We then came along and we backed, with other business groups in coalitions we were with, the budget cuts. We did not get into the nitty gritty of it as to where the budget should be cut; that is your job and the President's job to do that. You are more familiar with that than we are.

We backed budget cuts, because that was the way to get inflation down and the budget in line at that point.

We then also backed tax cuts—mostly for business incentives—but if they were necessary for the average person, fine—providing they did not exceed the budget cuts. We specifically pointed that out to the administration and the Congress in all of this.

Unfortunately, you know as well as I do what happened. At the end of those tax cuts, there were a lot of last-minute situations that occurred.

Now we are back to a situation where interest rates are not coming down as was predicted and as was hoped. We find ourselves in this situation.

I was just here two days ago with some of the other senior officers of the National Home Builders. We were at the White House with some of the key people in the White House. We did speak to them, and we presented these facts that we mentioned to you this morning.

About 1 week ago Saturday, one of our past-presidents—who is a staunch Republican and who did back this President from way back—met with one of his key people in Los Angeles. He presented to him in no uncertain terms the situation that was happening in this industry and explained that some of the support was eroding away at that point, and pointed out the President should bring this thing back into focus. Interest rates were killing the country at this point.

I think the President recognizes that. I am assuming that is the reason he is going on television tonight. He must get the word out to the American people and the Wall Street people and the banking industry that he is sincere about this.

To answer your question: Yes, we have brought this forward in letters, direct communication, and meetings and so forth.

Senator **Weicker.** Senator Nunn?

Senator **Nunn.** I agree with you that there were some things added in that conference in both the House and Senate on that tax bill which were probably very questionable.

There were also some things added on, as I define supply side economics, that really were supply side economics—for instance, the Chafee bill, which was the bill that stimulates savings for IRA's. I think we all agree that savings are absolutely indispensable.

There were a lot of things added on that were good. There were some that were very questionable.

Under that category, I frankly think come some of the oil breaks that were added on in conference at a very late hour. I think that was very questionable. We have more rigs out there drilling now than we have had in 25 years. Whether we need any more incentive there is a real question to me.

Nevertheless I think it should be pointed out that the President's original tax bill was never matched by expenditure cuts and tax cuts. In the original bill, the tax cuts far exceeded the spending cuts.

There were amendments on the floor—at least two amendments—to try to match spending cuts in 1983 and 1984 with tax cuts by making those contingent. Nevertheless, that is history.

As I understand the theory of supply side economics, it was that we were going to cut taxes a lot more than expenses. However, the huge growth that was going to take place was going to make up that gap.

Somebody forgot to figure the 19.5 and 20 percent prime rate. Our economic gurus forgot to figure how you are going to have 5.5 percent real growth, which is what the Reagan administration still projects, although yesterday they said they were lowering that—or their spokesmen did.

How are you going to get 5.5 percent real growth when you have only a 3- to 5-percent growth in the money supply—not counting inflation.

You really have to get 12 percent nominal growth in order to meet the Reagan administration's 5.5-percent real growth figure. How you can get 12 percent growth in the economy with a 3- to 5-percent growth in the money supply, no one has ever explained.

It is incredible to me that a country which is built on the free enterprise system and is basically moving in a conservative direction would have embarked on this very radical theory which has never been proven in history. Nevertheless that is where we are.

Let me ask you this question: You mentioned that even if it is necessary to roll back some of the tax cuts in order to achieve these reduced budget deficits, your association would support that.

Mr. Napolitano. We believe the individual tax cuts, for the most part, are nonproductive. They will not do anything to lower the interest rates.

I think the business cuts for the most part will do something if the Wall Street people and the bankers are convinced that we will have inflation under control and that we will get that budget in line.

At that point, then I think we will see some production.

Some of our leading suppliers—Johns Manville and many others that I could mention—are telling us that they are not about to build any new plants—even with all the tax incentives—unless they are convinced that this administration and this Congress are really sincere about getting that budget in line and whether we are going to have a more or less level situation.

Senator **Nunn**. With the tax cuts, even the depreciation and all of that will only help businesses that are able to get the capital to make the investments. It would qualify them for the tax breaks.

Mr. **Napolitano**. That is right. Some of the individual cuts help our builders, because we are small business people and we pay taxes like anyone else. However, that is providing that we have an income and we make some money.

Senator **Nunn**. You have to make some money.

Mr. **Napolitano**. Otherwise the tax cuts will not do us any good.

Senator **Nunn**. That is right.

We are going to hear from the farmers in a few minutes. I know personally that tax breaks for most farmers are not going to mean anything because they are not making any money anyway. You do not pay taxes without money.

Let me ask you this: What if there were an effort to spread out those tax cuts—say the individual tax cuts—over 6 years. It would be the same amount of overall cut but spread it out over 5 or 6 years. And/or make those individual tax cuts in 1983 and 1984 dependent on spending cuts, so that they would take place in proportion, which is what your original statement said, to spending cuts.

Instead of a $60 billion tax cut with a $20 billion spending cut, if we had a $20 billion spending cut the tax cut would be reduced.

Would your association be in favor of something like that if it were proposed?

Mr. **Napolitano**. Not being an economist and not knowing what those figures would do, I can only talk about the principle and the concept.

Anything that would get the budget in line to reduce interest rates I believe our association would endorse, within reason, of course.

Senator **Nunn**. The Federal Reserve Vice Chairman said yesterday that if there were a contingency on those 1983 and 1984 tax cuts—meaning they would go in effect in proportion to the spending cuts that took place—he felt it would have a significant impact on lowering interest rates. That was the testimony yesterday.

What we have is a $150 billion gap over the next 3 years. We have the tax cuts exceeding the spending cuts by $150 billion. I think that is why the markets are reacting as they are. They see huge additional deficits.

If you take the programs the President says he is not going to cut, which are basically social security and major entitlement programs—retirement and so forth—and you add that to the defense budget which is not being cut very significantly—which I happen to think should not be—and the veterans budget, which is another one of the sacred cows, and the interest on the debt, those four categories compose about six-sevenths of the entire Federal budget.

What you have to do, if you are going to make $150 billion in cuts over the next 3 years, is virtually eliminate almost everything else in Government, including revenue sharing, housing, education, and most of the health which is not in social security, which is about 50 percent.

You have to have such a huge impact on this that I think the social consequences would be staggering.

I am describing to you a real trap.

Unless the revenue side changes, I do not see there will ever be enough votes in the House or the Senate. I do not think you would even get a majority of the Republicans to vote for the kinds of spending cuts that would be necessary to plug that gap.

I am really hopeful that the President tonight is going to lay out a balanced package on both the revenue and the spending sides.

Mr. **Napolitano**. I agree with you on that. I am hopeful he will do that.

I am just a homebuilder. All I know is that if we build homes, we employ people. If we employ people, they pay taxes. When they pay taxes, that helps the revenue side.

That is not happening right now. It is not happening in our industry and many other industries in this country, except in the larger industries—defense, high technology, and oil. As the previous speaker mentioned, it could be 100 percent interest. They do not care about that. They can absorb it, and they can pay it. There is no problem with that.

Senator **Nunn**. I think Mr. Meyer pointed out that the inventory of houses in Savannah, Ga., is going down and down. The amount being built is going down and down.

As I understand supply side economics, that is just the opposite of what this program is intended to do. Is that your understanding, too?

Mr. **Meyer**. Absolutely.

Senator **Nunn**. One of the most desired commodities in America is housing and everyone has a dream for that. The supplies are going down dramatically—meaning as you said that it is very difficult to see, when the demand is still out there and the supplies are going down, how you are going to have a reduction in cost.

Mr. **Meyer**. For the past 3 years, I have built between 24 and 30 houses each year. This year I built six.

If you had the desire to take the chance at the interest rates we pay on construction loans, it is pure folly to even consider walking into a bank and asking for a speculative construction loan right now. Their attitudes are so negative that unless you are set up with the retained earnings in cash to cover your interest charges for a period of 24 to 36 months, you might as well forget that.

There are some builders who can do that in Savannah, Ga., but not many. Their base is being eroded gradually as well.

We have an average of 2.3 houses per builder available in our association.

Senator **Nunn**. Thank you all very much for coming and testifying. We appreciate your being here.

Senator **Dixon**. I just want to say to these fine gentlemen that my senior Senator, Senator Percy, and myself met with the homebuilders from our State last week at great length. Their story was exactly the same as yours.

Last weekend I was in Carbondale, a small town in southern Illinois of about 30,000 people, in the company of a personal friend of mine who is a very small homebuilder down there.

I asked him how things were, and he said that at this time of the year he usually has three in the ground and two ready to go. He has nothing at all. None of his folks are employed.

I think the curious thing about that is that this is prevalent all over my State; there are no exceptions to that. Yet I am told that in Hilton Head and Palm Beach and Palm Springs and places like that, they presell all the homes. The wealthy still can have a second home in Hilton Head and Palm Springs, but on main street in Bellville nobody can afford one.

Mr. **Meyer**. I believe they are selling Mercedes as fast as they can ship them into the country as well, sir.

Senator **Dixon**. We have a curious society when that occurs, Mr. Meyer.

Mr. **Napolitano**. I would like to add just one thing, if I may, based on something you just said.

At a meeting with Mr. Volcker about 3 weeks ago, I tried to get an idea from him as to when things would start to ease up. I told him that our bankers—who are holding these builders together to some degree and say they will see how long they can hang in there with—are beginning now to say: "You cannot hang on much longer. We are going to have to let you go."

I told Mr. Volcker that if he could at least show some encouragement—and I said this to the administration as well—so that our bankers will stay with our builders, then if and when it does turn around we might be able to salvage some of these people and they will start to be productive again. He said: "I cannot do that without it seeming like we are caving in." I said: "But these are small business people we are talking about. Their life savings are going under. They have worked 30 or 40 years in some cases, and they are losing everything. Give them a fighting chance." The only answer was: "We have to look at the big picture."

It is a sad society when we start to do that and your middle-class Americans and small business people are going down the tube.

Senator **Nunn**. I am afraid that big picture represents the big banks and the Fortune 500.

I think the big picture in America is the small businesses who have made this country great.

Mr. **Napolitano**. That is right.

Senator **Nunn**. I think we ought to look at the big picture, but they are missing the big picture.

Mr. **Meyer**. Senator, we even have that to some degree in our industry.

I was speaking recently with a gentleman who is a public relations specialist with Atlanta Gas Light Co. which is the Georgia natural gas supplier. He was inquiring of the massive U.S. Home corporation as to why they were coming into Atlanta in eight or nine subdivisions and building multitudinous houses.

The executives with U.S. Home told the gentleman with Savannah Gas or the Atlanta Gas Light Co. that it was their opinion that the 2,200 builders in Atlanta would dwindle to 1,100 by the first quarter. Therefore, they were standing by to fill those gaps.

It is the same situation, even though it is still within the housing market, of the small businesses falling prey to the larger companies that come in with their own mortgage companies. They raise money through bond issues for permanent mortgages. They import their lumber from outside the trade areas and bring in outside labor. It is the same issue of big business versus small business to some degree.

Senator **Nunn**. You are saying that even when this cycle is over, hopefully quickly, you are going to have a totally different makeup in the housing industry. It is going to shift toward big business.

Mr. **Meyer**. I would say that if it changed tomorrow, we have already undergone changes. These changes will continue on 30-day periods as we go through this recession.

Senator **Weicker**. You see that in the business allied to yours—the real estate business. The idea of small independent real estate firms is out the window, because they cannot get financing for their potential customers. Merrill Lynch and Coldwell Banker are in there. All these big fellows come in and buy up all these individual real estate people because they have the capital.

Fred is correct, because he and I have been tracking this problem through your association for not just this last couple of months but we have seen this one coming over the hill for quite awhile.

I have real doubts as to what this concentration of economic power is going to produce. There is no doubt in my mind that we get the best product and the lowest price in this country when we have the most competition. That is what I see flying out the window.

Mr. **Napolitano**. Most people in Washington, especially, do not realize how our industry works. They think you can just turn on a faucet and all of a sudden you have housing.

I told Mr. Volcker that if somehow the interest rate were to come down drastically, the day after I was speaking to him, it would take until next spring or summer to see a viable building business moving again. That is how long it would take us to gear up. And do not forget that we are going over the winter months, which kills a lot of our building industry in a lot of parts of the country.

It is not something where if you lowered the interest rate tomorrow you would see this thing booming. It takes time to gear up to it.

The more people who go under in our business, the more you are going to see the large company coming in Savannah and Connecticut and so forth. Instead of 200 builders building on a competitive basis, you will see one company doing all the building.

If you do not think the prices are going to be high at that point, think again.

Senator **Weicker**. I agree.

This is my last question, because we have to get on to the next panel unless my colleagues have some further questions.

There was an intimation—I believe it was Mr. Schultz yesterday—in any event, someone either from the administration or the board—that the problem as far as home building was concerned was not so much high interest rates as high prices for homes.

For example, what do your homes sell for now and what kind of a market are you trying to reach with your homes?

Mr. **Watson**. Basically, I am building for the middle income in our area. The price of my homes is in the $50,000 price range.

Even though I agree that housing and inflation have gone up, when interest rates were lower and we had inflation, I could still sell housing. Now with high interest rates and even with moderation on inflation, I cannot sell housing.

We can buy money down to lower interest rates. It costs more than what the interest rates are, so it is a fictitious number you put out to the general public if you buy down an interest rate. You are adding it back on to the cost of the house, and buyers cannot afford the whole package.

Senator **Weicker**. Fred pointed out what goes on in the way of thinking in this town. The average price of a house around here is over $100,000. This man is dealing in $40,000 to $50,000 homes, and Connecticut is certainly not a cheap labor market. It never has been.

Obviously, what people were doing before is that they had faith in their future. Admittedly, maybe they could not afford that the year they bought it; but they had no doubt as to their future. That is what they were gambling on.

That is fine. That attitude, as far as I am concerned, is not an inflationary attitude or a spendthrift attitude. That is what this country has always been about.

I would agree that the problem is not the price of the house. I think it is the interest rate.

Gentlemen, I thank you very much. It was good to have you here.

As you said, Mr. Meyer, I do not think the circumstances are such that we would like to have you here. However, hopefully, there will be happier days ahead.

Senator **Nunn**. Thank you all very much.

[The prepared statement of Mr. Napolitano follows:]

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STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS
before the
SELECT COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE
on
INTEREST RATES AND BUSINESS CREDIT NEEDS
SEPTEMBER 24, 1981

Mr. Chairman, Senator Nunn and Members of the Committee:

My name is Frederick J. Napolitano and I am a homebuilder from Virginia Beach, Virginia. I am testifying today on behalf of the more than 123,000 members of the National Association of Home Builders (NAHB), of which I am President-Elect. Joining me at the witness table today are two fellow homebuilders, Clem Watson from Norwich, Connecticut and Craig Meyer, President of the Savannah, Georgia Home Builders Association. Also accompanying me today are Robert D Bannister, Senior Staff Vice President for Government Affairs and Jim Schuyler, Staff Vice President and Legislative Counsel for Governmental Affairs.

For the past 30 years, I have been active in the construction industry. As President of Napolitano Enterprises I have built more than 6,000 homes and developed more than 5,000 lots. I have also been involved in the development of shopping centers and office parks.

We are deeply appreciative to the Chairman and Senator Nunn for scheduling these most timely hearings on the devastating impact of high interest rates on small business.

Mr. Chairman, it is traditional for a witness to say how pleased he is to appear here today. But as I think of why I am here and the condition of the economy, the word "pleasure" does not easily come to mind. Words like "deeply troubled" and "impending catastrophe" seem much more appropriate.

But this Committee knows that ... and has recognized this situation far longer than the rest of Congress and the prior or current Administation. Mr. Chairman, your Committee has given us a forum to express our views since November of 1979 when we warned that the actions of the Federal Reserve Board on October 6, 1979 could lead to "a catastrophic collapse of the housing industry, with its attendant loss of jobs, loss of federal revenue and devastating impact on the homebuying public." And I don't think that we exaggerated the impact. In fact, if we had followed some of the economic prescriptions recommended by this Committee and its Chairman over the last two years, I don't think that I would be appearing before you today with such a dismal short-term economic outlook for housing.

OUTLOOK FOR HOUSING

What is the current state of the housing industry? Mr. Chairman, one of the largest and most important "small business" industries in America is virtually out of business.

- New housing production for August was at a seasonally adjusted annual rate of 937,000 -- the lowest monthly rate since February 1975.
- Our projections indicate that housing production for 1981 may end up at only 1.07 million units -- the lowest year since 1946. Unless interest rates decline sharply, 1982 production levels will not improve very much.
- What about jobs? According to government statistics, 863,000 wage and salary workers in construction are unemployed. Add to this figure about 200,000 more who are self-employed.
- The unemployment rate of 16.7% (more than double the overall rate of unemployment) will likely increase to 21% by the end of the year -- and go higher in early 1982.
- A mere 2% of builders report that sales are "good to excellent." That compares with 70% to 80% in a good year.
- Traffic at subdivisions is almost non-existent -- fewer than 7% of builders report traffic to be "good to excellent." That compares with 40% to 50% in a good year.
- Failure rate among construction firms is up 41% for the period January to August 1981 as compared to the same period in 1980. Failure rate among subcontractors is up by 120%.
- Mortgage money generally is not available, and what is being offered is at record rates. Freddie Mac yields are over 19% in mid-September.

In short, housing activity has come to a standstill across the country in the face of persistent high interest rates. And our nation's homebuilders are fighting for survival against mounting odds.

ECONOMIC IMPACT

What is the economic impact? From the beginning of the slump in 1978 until today, we estimate that this housing downturn has cost the American economy more than 2.8 million man-years of employment, $49.2 billion in wages and $15.7 billion in total tax revenues. The total overall economic impact has been $223 billion.

The long-term effects will be at least as damaging. The record demand for housing will continue to go unmet, thereby increasing inflationary pressures during the housing recovery. Thousands of skilled craftsmen have sought employment elsewhere and will not return as the housing industry rebounds. Consequently, a new workforce will have to be trained when economic conditions improve. Building material manufacturers have gone out of business and others have indefinitely delayed any plans to expand production capacity. As in past housing cycles, we will find serious shortages of building materials when production picks up. All of this translates into higher housing prices for housing consumers who are already stretched to the limit of their ability to pay.

Finally, and most significant for this Committee, I believe that we will see a major shift away from the "small business" character of this industry when the market is revived. Business failures are up by 41% over last year, and the smallest and least capitalized firms are the ones which are most likely to go under. The net result will be fewer and larger building firms. And, Mr. Chairman, that would be a real tragedy. This industry could lose one of its basic strengths if we lose our base of smaller, fiercely independent and competitive builders.

HOUSING CONSUMERS

What can I say regarding the homebuying and renting public? We have emphasized repeatedly in our appearances before this Committee the record demand for housing during this decade. Projections indicate that in the 1980's some 41 million people will reach the prime homebuying age of 30. This compares with about 31 million who reached the age of 30 during the 1970's. The rate of new household formations will be 25 percent higher in the 1980's than during the last decade. All I can add is that if housing production is at about the one million level for the first two years of that decade, we will fall even further behind in meeting that demand. And I believe that unless this demand is met, there will be a revolution at the ballot box in 1982 and 1984.

Let me quote from a letter to the editor of the Business section of the New York Times last Sunday. "If Mr. Average American can no longer own his own home, what does that do to his sense of involvement? Think about it. Lack of mortgage money will tend to destabilize the United States." We share the view that homeownership provides benefits to society far beyond the provision of shelter. These effects are economic, social and political. Obviously, housing production has a substantial direct impact in terms of job creation for construction workers, building material suppliers and the entire network of subcontractors. In addition, there is a significant multiplier effect on the whole range of industries which provide products and services for the home. The social benefits of housing are perhaps less tangible but equally as important. The opportunity for homeownership promotes stability and a sense of well-being for the American family. Decent housing allows for privacy and the sense of pride that accompanies ownership of property. Finally, the most important aspect of meeting our housing needs may be political. Homeownership and the ability to live in decent and safe housing gives our people the chance to become a part of the capitalist system. Historically, this has led to a strong middle class, which reflects political stability and security. The ability to own a home is still a fundamental part of the American dream and a continuing aspiration for almost all of our people.

But what is today's reality? Unfortunately, the numbers on affordability tell the sad story simply but graphically.

A modest $60,000 mortgage loan at 9% interest - the going rate two years ago - required a monthly payment of $483. At 17 1/2%, the payment is $880 per month, almost double the payment of two years ago. In order to meet those monthly payments, a family would need an annual income of almost $40,000. Only 18% of the American people have an income high enough to afford that home, and virtually no first-time homebuyers would qualify for a home at those interest rates.

UNLOCK THE ECONOMY PROGRAM

In order to focus national attention on the impact of high interest rates on credit sensitive industries, we have embarked on an "Unlock the Economy" campaign which was developed at our NAHB Board of Directors meeting earlier this month. We have joined in a coalition with the National Association of Realtors and the National Automobile Dealers Association (who are appearing before you today).

There are three basic elements to this program to combat high interest rates:

- First, we call upon the Administration and Congress to meet the initial Administration targets of less than $42.5 billion deficit in FY'82 and a balanced budget in FY'84. We recognize that this will require substantial reductions in defense expenditures and additional cuts in non-defense expenditures as well as reductions in entitlement programs. It may even involve deferral of the individual income tax reductions already approved by Congress.
- Second, we then call upon the Federal Reserve Board to institute policies that will allow the money supply to grow at the upper end of the ranges of the Fed monetary targets and at a rate that will accommodate economic growth and stability. In this effort, we seek the support of the President and Congress for this change in Fed policy.
- Third, we seek to broaden the representation on the Fed Board of Governors to include representatives from the credit-sensitive small business sector of the economy. We would support the appointment of a non-banking small business person to the Fed when the term of Vice Chairman Schultz ends early next year.

Regarding issues which specifically affect housing, we believe that there are a number of areas which would have a positive short-term and long-term impact.

First, we strongly believe that immediate action must be taken to make the tax-exempt housing bond program workable through passage of technical correction legislation sponsored by Senator Jim Sasser and Senator Howard Baker (S.1348). In addition, the Treasury Department should redraft and simplify the complex and unworkable regulations issued for the single-family program. The Treasury Department should also act expeditiously to issue the regulations implementing the multifamily program.

Second, we have drafted legislation to encourage increased pension investment in mortgages by eliminating the so-called "prohibited transaction" provision in the ERISA law and by recognizing investment in residential mortgages as a "prudent investment."

Third, we believe that there should be increased Congressional oversight of Federal Reserve Board activities, and we would support legislation to shorten the term of Fed members.

Fourth, we believe that the Credit Control Act, which is due to expire on June 30, 1982, should be reauthorized and consideration given to specifying conditions for its activation and direction given as to which powers should be exercised in order to more fairly share the credit burden throughout the country.

Mr. Chairman, I cannot in good conscience say that enactment of this program would lead to a healthy economy and a robust housing industry in the next three to six months. And because of the imminent danger of bankruptcy to many builders over that period of time, I am not optimistic about the short-term outlook. But such a program would give a signal -- to the Fed, to Wall Street, to the housing consumer and the homebuilder -- that we have begun to turn a corner and that if we can just hang on a little longer, then economic conditions will improve.

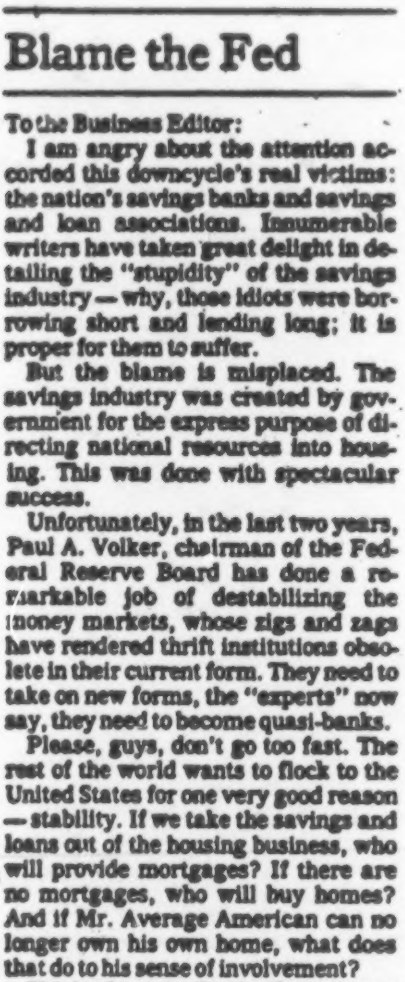
As I assume the leadership of NAHB in January, I would like to be able to give our members -- and the homebuying and renting public -- that message. Mr. Chairman, I hope that we can continue to work together to achieve that goal.

Let me say now that I have been very pleased to have the opportunity to testify this morning. I look forward to working with you and your highly competent professional staff. I would, of course, be happy to answer any questions you may have.

At this time, I am pleased to introduce my fellow builders, Clem Watson from Norwich, Connecticut, who has been a succesful single-family builder for many years and Craig Meyer, a loyal and active member of our Association who has served effectively as President of the Savannah, Georgia, Home Builders Association.

Attachment A

NEW YORK TIMES - 09/20/81



Blame the Fed

To the Business Editor:

I am angry about the attention accorded this downcycle's real victims: the nation's savings banks and savings and loan associations. Innumerable writers have taken great delight in detailing the "stupidity" of the savings industry — why, those idiots were borrowing short and lending long; it is proper for them to suffer.

But the blame is misplaced. The savings industry was created by government for the express purpose of directing national resources into housing. This was done with spectacular success.

Unfortunately, in the last two years, Paul A. Volker, chairman of the Federal Reserve Board has done a remarkable job of destabilizing the money markets, whose zigs and zags have rendered thrift institutions obsolete in their current form. They need to take on new forms, the "experts" now say, they need to become quasi-banks.

Please, guys, don't go too fast. The rest of the world wants to flock to the United States for one very good reason — stability. If we take the savings and loans out of the housing business, who will provide mortgages? If there are no mortgages, who will buy homes? And if Mr. Average American can no longer own his own home, what does that do to his sense of involvement?

Think about it. Lack of mortgage money will tend to destabilize the United States.

MICHAEL D. RAY
Costa Mesa, Calif., Sept. 11, 1981

Senator **Weicker**. The next panel consists of Mr. George Lyles, the first vice president of the National Automobile Dealers Association, High Point, N.C.; Mr. David Zinn, the vice chairman of the American International Automobile Dealers Association, Miami, Fla.; and Mr. Robert McElwaine, president of the American International Automobile Dealers Association of Washington, D.C.

It is nice to have all of you gentlemen here.

I hope, Bob, that you did not take any offense at the reference to Mercedes-Benz. [Laughter.]

I think it might be natural under the circumstances today.

In any event, I think you are here representing the Americans who sell the Mercedes-Benz. Those are American businesses and American people.

Please proceed in whatever manner or order you would like.

STATEMENT OF GEORGE W. LYLES, FIRST VICE PRESIDENT, NATIONAL AUTOMOBILE DEALERS ASSOCIATION, HIGH POINT, N.C.

Mr. **Lyles**. Thank you, Mr. Chairman.

My name is George Lyles. I am a Chevrolet dealer in High Point, N.C., and the first vice president and president-elect of the National Automobile Dealers Association, which consists of in excess of 20,000 franchise dealers in the United States.

As you are all fully aware, the automobile industry in this Nation is in the midst of a deep and severe depression. Domestic sales for 1980 were the lowest since 1963, while domestic production was the lowest since 1961.

As far as the small business dealer is concerned, the attrition rate is staggering. Over 2,500 dealers have closed their doors in the past 24 months and over 125,000 dealer employees have lost their jobs.

The experience of the past 24 months for automobile dealers has been devastating. Even more alarming are the prospects for the future if the current economic climate remains unchanged for any appreciable period of time.

There are hundreds of small business dealers that are, in effect, hanging on by their fingernails. If we continue to experience unreasonably high interest rates for several more months, these dealers will literally not survive.

If all the problems encountered by the industry had been relatively short in duration, most dealers could have weathered the storm. However, the industry's current predicament began in the spring of 1979 when largely as a result of the Department of Energy's arbitrary and disrupting gasoline allocation program, transportation fuel shortages occurred in many sections of our country. These shortages were soon accompanied by sudden and dramatic increases in the price of gasoline to the consumer. These two factors very quickly led to a substantial reduction in new car sales.

During the early months of 1980, the industry was hoping to reduce its inventory and recover the sales it had lost for months. However, largely because of the Federal monetary policy, interest rates continued to climb.

In March, the imposition of credit controls by the Federal Reserve Board resulted in an even further reduction in automobile sales.

The extremely rapid increase in interest rates as a result of the Federal action had grave consequences on the industry. The prime rate quickly exceeded many State usury limits. This, coupled with the collapse of the industrial bond market and the corresponding increased short-term borrowing by large industry, significantly reduced the availability of consumer financing for the purchase of new automobiles.

Although many consumers had decided to delay purchasing a new car because of record high interest rates, a great number of those who decided to purchase an automobile despite the high rates of interest found that they could not because financing simply was not available.

By May of 1980, an astounding 46 percent of those consumers who wished to purchase a new vehicle were turned down in their application for a loan, and these contracts were lost.

As credit controls were removed and interest rates started to fall in the summer, new motor vehicle sales began to pick up. Dealers once again looked to the period of new model introduction as an opportunity to increase their sales and get back on their feet. However, interest rates again started to quickly escalate, and new car and truck sales dropped at a rapid rate.

A survey of a sample of new car and truck dealers throughout the Nation revealed that in November, a period in which the prime rate went from 14 percent to almost 18 percent, the number of consumers visiting the showrooms—the floor traffic—was on the average 27 percent lower than the depressed levels of 1979.

In addition, the percentage of those consumers who actually purchase a vehicle has dropped 20 percent since interest rates started back up.

To make matters worse, even those consumers who decide to purchase a new car are having a hard time obtaining financing. The nationwide retail installment turndown rate for willing buyers of new vehicles is now approximately 30 percent.

However, the dramatic reduction in sales caused by high interest rates constitutes only one side of the double-edged sword being wielded at the small business dealer today.

Historically, a dealer must pay 1 or 2 percentage points above prime to floor-plan or finance his inventory. Since an automobile is a high-priced item, the monthly payment that dealers are obligated to make to finance their products becomes very substantial as interest rates move to unreasonably high levels.

As a matter of fact, the burden of high floor-plan charges during periods of low sales is the very condition that leads to bankruptcy.

As this condition continues longer and longer, failures among dealers will not only continue to increase but unfortunately they will increase at a greater rate because of the cumulative effect of the extended depression.

If present conditions continue for any appreciable period of time, hundreds and perhaps thousands of additional dealers will be forced out of business.

A number of experiences in recent years has made it abundantly clear that as interest rates escalate, the automobile and housing industries immediately suffer. This fact is no longer subject to question.

Therefore, now and in the future, when Government monetary policies force interest rates to high levels, the dealer body must view such policies as a conscious attempt and willingness on the part of the Government to sacrifice the automobile and housing industries.

If we, as a Nation, can find a no more effective way to control inflation other than to force up rates of interest, then we must immediately set about to structure mechanisms that will assist the automobile and housing industries throughout these troubled times so that they will no longer be forced to shoulder such a disproportionate share of the national sacrifice.

We join with the homebuilders associations and the realtors to urge Congress and the administration to lower this present rate.

While we do not have a quick and decisive solution to the problem of high interest rates, it seems apparent to our dealer body that the policy and practice of huge deficit spending by the Federal Government has been, and continues to be, a major contributing factor to the problem.

As long as the Federal Government's credit demands remain high, interest rates will remain high. We feel that is absolutely imperative that the Government take immediate steps to remedy this situation.

However, we are aware that this effort, even if undertaken conscientiously, will take several years to bring the enormous deficit spending under control. In the meantime, we desperately need short-term relief. This is a difficult problem, but we believe that a degree of relief can be obtained through a slightly altered and relaxed Federal Reserve Board policy.

It is our understanding that the Federal Reserve Board has been overly cautious during the past several months and has actually been holding the money supply below its target level. This caution is probably the result of the Fed's experience of approximately a year ago when the money supply increased quickly and interest rates dropped, only to escalate to new highs within a few months.

In today's environment, however, we cannot afford an overkill. We would suggest that the Fed increase the money supply at least to a point within its target range. This would certainly be a responsible act by the Fed and would probably cause a slight drop in interest rates. Even a small reduction in interest rates would help the dealers in their struggle to survive.

Mr. Chairman, I appreciate this opportunity to appear before you. I would be happy to attempt to answer any questions that you might have.

Thank you.

Senator WEICKER. Thank you.

Mr. McElwaine?

STATEMENT OF ROBERT M. McELWAINE, PRESIDENT, AMERICAN INTERNATIONAL AUTOMOBILE DEALERS ASSOCIATION, WASHINGTON, D.C.

Mr. **McElwaine**. Mr. Chairman and Senator Nunn, there is no way that I can add to the tales of personal tragedy and human indignity as a consequence of high interest rates which this committee has been exposed to yesterday and this morning.

I would prefer a few minutes here to dwell on the positive impact that a reduced interest rate would have, in particular, on our industry and in general on the overall economy.

We have just done a survey of a representative sampling of our membership in which we asked them the consequences of an interest rate level around the 10- to 12-percent range, which is what the current inflation should actually be calling for.

Nine out of ten of the dealers we talked to responded that an interest rate at that level would enable them to carry out a business expansion; building new dealerships or new showrooms and new working facilities that would mean hiring additional salespersons, additional mechanics, and additional clerical workers, plus all the construction workers that would be involved in the bricks and mortar aspects of this expansion.

Senator **Nunn**. May I just ask you one question, and I do not mean to interrupt you.

If you had your choice—and this is just hypothetical; I do not think it is simple and do not want to indicate that it is—as far as stimulating the automobile business between the tax cuts that just went into effect or a 10-percent prime interest rate, which would you choose?

Mr. **McElwaine**. If I did a survey of our 7,000 dealers in this business, Senator Nunn, I would say 6,850 would vote in favor of a lower interest rate over the tax cut. Almost none would support it.

Listen, for example, to some of the words of these small businessmen:

> Less-costly money would mean I could move on an additional piece of property. If I were to buy it, it would put plumbers and carpenters to work. In the meantime, it is just standing there.
>
> High borrowing costs have delayed the proposed expansion of our workshop facility which precludes hiring employees expected to fill these productive work stations in our service departments.
>
> A ten percent prime would allow us to make some improvements that we really need to do that I am holding back on—pavement, the roof of the building, etc.
>
> Any person who would consider any expansion in these days would have an unusual set of circumstances or he is a damn fool.

One hundred percent of the dealers surveyed said that a reasonable level of interest would act to stimulate business greatly.

Listen to just one dealer out of these hundreds:

> A 10 percent prime? Hallelujah. Things would turn around, absolutely. You could finance your paper; you could sell cars; you could stock cars; you could advertise; you would have some loose capital. Ten percent? Yeah, we could go all out and start all over again.

That is just typical of the reaction that we got from these dealers.

Senator **Weicker**. That shows how the times change—when anybody says hallelujah to 10 percent.

Mr. **McElwaine**. Five years ago we would have thought it was atrocious.

High interest rates are pernicious as well.

While halving the prime rate in the next few months would release an explosive upsurge in business activity, the same action taken a year or two from now would probably be unsuccessful in lifting the economy from the doldrums into which it is very clearly heading.

In a year or two, these cutbacks in productive capacity that these record interest rates are bringing about are going to become a permanent part of our national economic picture. Recovery is going to be longer and infinitely more painful. The longer this is held up the longer it is going to take to get out of here.

These high interest rates are having a debilitating effect on what has been really one of the bright spots in our economic picture for several years, which is our balance of payments.

In 1980, we had a surplus in our balance of payments of $4 billion. This year, due to the fact that high interest rates have increased the value of the dollar disproportionately to its value in connection with other currencies, we are going to have a deficit in our balance of payment of between $15 and $20 billion. That is a swing of about $25 billion in money in the United States as a direct consequence of high interest rates.

Our exports are more expensive now for foreign buyers because of this. Our imports are cheaper here with a consequent negative effect on sales, both abroad and in the domestic market.

These high interest rates are primarily responsible for the increase in the merchandise trade deficit with Japan, and Lord knows it was high enough last year. It was $10 billion last year; it is going to go to $14 or $15 billion this year as a direct consequence of these high interest rates, which of course will bring all of the protectionists out of hiding. They are going to demand protectionist actions against Japanese imports because of the imbalance, which is due to high interest rates. That affects us immediately, of course.

By all measures, the eighties should be a period of unmatched prosperity in American history. The economists have forecast a tripling in our gross national product by 1990. There are going to be 32 million more households added to this country in the decade of the eighties. There is going to be a massive growth in the 25-to-35 age group which is the group who buy new homes and new cars and who really stimulate industry and business in this country.

This is going to be accompanied by a sharp decline in unemployment and by a massive decrease in income taxes.

High interest rates are like a pair of concrete overshoes on this economy. It will never take off and never achieve this kind of growth under these high interest rates.

Thank you.

Senator **Weicker**. Mr. Zinn?

STATEMENT OF DAVID ZINN, VICE CHAIRMAN, AMERICAN INTERNATIONAL AUTOMOBILE DEALERS ASSOCIATION, MIAMI, FLA.

Mr. ZINN. Mr. Chairman, my name is David Zinn. I am from Miami, Fla., and I am an import automobile dealer and vice chairman of the American International Auto Dealers Association.

From time to time, various manufacturers have designed marketing devices and techniques that have produced successful results. Nothing has produced the instant success that General Motors has achieved with their 13.8-percent interest loans to buyers of new General Motors cars financed by GMAC through their participating dealers who, I might add, paid one-quarter of the difference in the interest rate out of their profits.

This resulted in General Motors sales—and, most particularly, GMAC contracts—that totaled 215,000 contracts which set an all-time record for any single month in an automobile market that has been severely depressed.

No doubt this is an indication of what lower interest rates would mean to the automobile industry.

In addition, we can be certain that Ford Motor Credit and Chrysler Credit Corp. are taking a long and hard look at this new marketing innovation. We can be sure that they will be heard from with some variation of their own with an interest incentive that will no doubt stimulate sales for their companies.

Who is to help the import automobile dealer? We have no GMAC; we have no Ford Motor Credit; we have no Chrysler Credit Corp. All we have is our local banker.

In the State of Florida, which caps the finance interest rate at 18 percent for retail purchase of an automobile, the bankers are not interested in making 18 percent loans to workers, laborers, unskilled people, and even highly professional people when they can put these same funds in overnight investments through the Fed that are paying 18 to 20 percent with no risk whatsoever and their money is guaranteed.

We have our vehicle inventory floor plan at 2 points over prime—22 to 23 percent. Somebody comes in to buy a car, and the maximum they can charge this person is 18 percent. There is a risk factor—deterioration of the product. Perhaps it is not cared for. Perhaps the vehicle will not be taken care of so that if it did have to be repossessed, the collateral may not be what it would be if they devote these funds totally in the direction of Government securities.

Our bankers care very little about what happens to the automobile dealers. I would liken it to what the bankers feel about the builders in the housing industry.

However, GMAC, Ford Motor Credit, and Chrysler Credit have an incentive. That incentive is to buy the contract and deliver a retail vehicle.

The bankers could not care less about the dealers who deliver or do not deliver cars.

In my case, the bank which traditionally bought the bulk of our retail contracts has abandoned this segment of the market entirely and will only finance a car for an existing customer with an open account in that bank which is considered excellent by the bank's standards. No one else has a chance.

A secondary smaller bank which was an additional source of financing for us has taken some of our recent contracts as a favor to me but has limited their participation to one finance contract a day. Any one I choose—they will buy one contract a working day.

I cannot survive delivering one car a day when we are accustomed to delivering 1,500 to 2,000 cars a year.

General Motors has demonstrated for all of us the effect lowering high interest rates would have. Unlike our predecessor who was devoting his testimony to the housing industry, he stated that it would be next spring before any impact of lower interest rates would be seen in the housing industry. The automobile industry would have an instant response and an instant upswing in business.

We know the devastating effect high interest rates have had on our industry—2,500-plus dealers have gone out of business in 2 years. The manufacturers are likewise at a disadvantage in their need for expansion, for increased productivity and more efficient technology; because they, too, are handicapped by prohibitive interest rates.

If Government can do something to lower interest rates to an acceptable level, there would be an instant response by the public that would put the auto industry back on its feet firmly.

The high interest rate and tight money policies are now contributing to the inflation that they were put in place to cure.

We, in the retail auto business are one of the unfortunate victims of these circumstances, and we need help now.

Thank you.

Senator WEICKER. Thank you all very much.

There really is little that I could ask in the way of questions that has not been covered in your statements.

Let me just ask one question: Do any of your members think there is a conscious attempt here to have the impact fall on housing and automobiles? There must be a recognition of the fact that the big ticket items are the ones that get hit the hardest.

Mr. MCELWAINE. There are many dealers, Mr. Chairman, who say: I know I am paranoid, but what if they really are after me? A lot of dealers would subscribe to the feeling that this is aimed at the housing and automobile industries. I do think that is a little on the paranoid side.

We simply happen to be in the way of a policy, and we are being run over by that policy.

That, essentially, is why we are here to talk to this committee—to ask that this committee join with other concerned committees and with the full Senate itself to urge the administration and the Federal Reserve Board that today's high interest and tight money policies be eased.

The 22-percent interest, which is what dealers are paying, is as ruinous as the inflation it was designed to correct.

Senator WEICKER. Is there any move on the part of any of the automobile companies—foreign or domestic—to move in and acquire the dealerships or franchises as they go under?

Mr. Lyles. As far as the domestics are concerned—GM expressly—there is absolutely no indication that anything like that is in the wind.

For some of the importers, there might be a different situation.

For the domestics, I would say the trend is not in that direction.

Senator Weicker. Let us carry this to its logical conclusion.

What if you are a Chevrolet dealer and sufficient Chevrolet dealers go belly up? How are they going to sell their cars?

Mr. Lyles. That might be something down the road, but it certainly is not in the planning stages at all. It is not part of the program.

If it happens that they are not Chevrolet dealers, it might come around to that. In my opinion, however, it would not come to that.

Senator Weicker. Didn't you give us a figure of your membership as to how many have gone out of business in the last year?

Mr. Lyles. That is right. Our membership is in excess of 20,000; 2,500 have gone out over the past 2 years.

Senator Weicker. That is 10 percent.

Mr. Lyles. Yes, sir.

Senator Weicker. How would you like to have another 10 percent?

That is substantial. Those are big figures.

If another 10 percent go under, it seems to me that somebody is going to have to take up the slack.

I just wonder whether the same process is not going to take place in your industry which is taking place in many of the other industries—homebuilding, real estate, and so forth—where the companies themselves move in if they have the capital or the access to capital and you do not.

I wonder if it is not going to have to be that type of solution.

Mr. McElwaine. What you have in the imported automobile industry is increasing multidealership ownership.

The average dealer sells 300 cars a year. That is a very small business. What you are seeing now is that one dealer may have five and six different franchises. The dealer with money, capital, and backing is gradually acquiring more and more franchises.

You are also seeing a great many domestic dealers. There are some 3,500 domestic dealers who have an import franchise which has probably been keeping a lot of them open.

Mr. Lyles. This is absolutely true.

The domestics have suffered considerably more than the Japanese imports. There have been some problems in European imports, but the domestics have suffered extensively. In some cases, and a lot of cases, the import popularity has assisted in the survival of quite a few of the domestic dealers.

I do not think that we consciously think that we are being picked on as far as an industry, because we did not mention the savings and loan industry which is also affected adversely as much as any other industry by high-interest rates.

You do read daily about different programs that are anticipated as being implemented to assist that industry that does have the same problem as the homebuilders, realtors, and the automobile industry.

We feel that the Government is a little insensitive to our problem.

Senator **Weicker**. Gentlemen, thank you very much for giving us your time.

[The prepared statement of Mr. Zinn follows:]

Testimony Before The

U.S. SENATE SELECT COMMITTEE ON SMALL BUSINESS

By The

AMERICAN INTERNATIONAL AUTOMOBILE DEALERS ASSOCIATION

David Zinn, Vice Chairman
Robert M. McElwaine, President

Washington, D.C.
September 24, 1981

The negative impact of prevailing high interest rates on small businesses has been well delineated before this committee: reduced sales due to higher financing costs, lowered profits because of the high cost of inventory financing, bankruptcy and business closings as a consequence of the inability to obtain, or to repay business loans made at more than twenty percent interest.

Even more significant to the health of our economy and the future growth of this nation, however, are the positive effects that a reasonable level of interest would have. To ascertain what those effects would be, AIADA recently surveyed a representative sample of its membership. The results were impressive. Perhaps the most outstanding single finding of the survey was that a prime rate in the range of 10 to 12 percent would add 25,000 jobs to our sector of the economy.

Nine of ten dealers responding to our survey indicated that a reasonable interest rate would enable them to carry out postponed improvements or expansions in their dealerships. These planned expansions would mean hiring additional salespersons, mechanics, clerical workers. In addition, such bricks and mortar expansions would mean more employment for construction workers all over America.

Listen to some of the words of these small businessmen:

"Less costly money would mean I could move on an additional piece of property nearby. Because the money cost is so high, nobody else is buying it. If the cost of money came down, I would move in and try to buy it. If I were to buy it, it would put plumbers and carpenters to work. But in the meantime, it's just standing there."

"High borrowing costs have delayed the proposed expansion of our workshop facility . . . . which precludes hiring employees expected to fill those productive work stations in our service department."

"No way would I consider doing any expansion at this time. We had contemplated some expanding, but now we're just making do with what we can."

"A ten percent prime would allow us to make some improvements that we really need to do that I am holding back on; such as pavement, the roof of the building, etc."

"Any person who would consider any expansion in these days would have an unusual set of circumstances or he is a damn fool. A ten percent prime would let us consider the possibility of expansion in bricks and mortar and in services. That would automatically increase employment."

One hundred percent of the dealers predicted that a reasonable level of interest rates would act to stimulate business greatly. Listen again to the words of the dealers:

"A ten percent prime? Hallelujah! Things would turn around - absolutely! You could finance your paper, you could sell cars, you could stock cars, you could advertise and you'd have some loose capital. Ten percent? Yeah! We could go all out and start all over again."

"Lower financing rates would attract people into the market. There is an inclination to buy, but a hesitancy because of the costs in buying the product and financing it. People who can elect to wait, do wait."

The effect reduced interest rates would have on the automobile market is illustrated by the success of General Motors' incentive program, offering 13.8 percent interest loans to buyers of new GM cars. In August, GM wrote 215,000 loan contracts, the highest for any single month in General Motors history. The lure of lower interest rates pushed GM's share of the domestic market from 60.5 to 64 percent in one month. Industry analysts called it a "big swing" in sales.

This "big swing" took place in a depressed market and in spite of the fact that more than one-quarter of the interest saving came out of the dealer's profit (and was probably reflected in a lower discount).

It is obvious that a tremendous upturn in business activity is simply waiting on a return to a reasonable level of interest. This economy has proved to be strong and resilient, but high interest rates are a ball and chain on its performance. Dealers are paying two points over prime for inventory financing today.

That means interest charges in the range of 22 to 22½ percent -- rates formerly charged only by people with names like Harry the Horse and Big Louie.

High interest rates are pernicious, as well. While a halving of the prime rate in the next few months would release an explosive upsurge in business activity, the same action taken a year or two from now might be unsuccessful in lifting the economy from the doldrums into which it is clearly heading. In a year or two, the cutbacks in productive capacity which record interest levels have forced will have become a permanent part of our national economic picture and recovery will be longer and infinitely more painful.

The negative effects of high interest rates on our domestic automobile industry are apparent and documented. More than 2500 dealers have closed their doors in two years. The domestic manufacturers, needing to finance the greatest expansion in productivity and product innovation in their history, are handicapped in their drive to become competitive on a global basis by money costs that are, in some cases, double those of their overseas competitors.

Our record high interest rates are also having a debilitating effect on the United States balance of payments - for the past few years one of the few bright spots in our economic performance. The phenomenal rate of return being paid for the use of money has attracted investors from all over the world, boosting the dollar's value disproportionately in relation to other currencies.

This makes our exports more expensive for foreign buyers and imports cheaper here, with consequent negative effect on sales both abroad and in the domestic market. As a consequence the U.S. expects a massive turnabout in its balance of payments, with its current account swinging from a $4 billion surplus for 1980 to a record deficit of $15 to $20 billion for 1981.

High interest rates are primarily responsible for the growth in the merchandise trade deficit with Japan from $10 billion last year to $14 or $15 billion this year. European nations also expect their trade balances with the U.S. to be altered substantially.

By all measures, the eighties should be a period of unmatched prosperity in American history. Economists have forecast a tripling of our gross national product by 1990; there will be 32 million more households established during the coming decade; there will be a massive growth in the 25-35 age group, the group that will need new cars, new homes and all the consumer goods that go with them. This growth will be accompanied by a sharp decline in unemployment and a massive decrease in income taxes.

We stand on the threshold of a new era of growth and prosperity. But high interest rates are shackling this economy and rapidly reducing the prospects for future expansion. The effect of these rates is much higher on small businesses than it is on the major corporations. A car dealership cannot issue bonds, sell additional stock, issue commercial paper or borrow from its overseas affiliate. For financing, for expansion, for inventory and for consumer purchases, he is dependent, solely, on loans from his bank.

On behalf of the 7000 imported automobile dealerships in this country and their 165,000 employees, we ask this committee to work with all concerned committees and the full Senate, to urge the Administration and the Federal Reserve Board that today's high interest, tight money policies be eased. Twenty-two percent interest is as ruinous to the economy as the inflation it is designed to correct. There must be a more moderate course. The Federal Reserve Board has it in its power to lower interest rates and ease the money supply. The Administration and the Congress have it within their power to reduce the deficit and the government's usurpation of the money markets.

We ask that steps be taken to bring about these desired results, not just to correct the distortions and imbalances in our present economy, but to release the full power and strength of the American economy to realize the potential it has today.

Senator WEICKER. The last witness to appear before the committee is Mr. Ned Harman, president of Georgia's Young Farmers, Carrollton, Ga.

It is nice to have you before the committee. You may proceed with your statement in any manner you wish. You may either read it in its entirety or summarize or whatever way you are most comfortable.

STATEMENT OF NED HARMAN, PRESIDENT, GEORGIA'S YOUNG FARMERS, CARROLLTON, GA.

Mr. HARMAN. Thank you, Mr. Chairman. It is an honor for me to be here.

I am Ned Harman; I am 36 years old. I live near Carrollton in northwest Georgia. I am married and have five children.

My family operation consists of 1,000 acres owned and rented. I have a 175-beef cow-calf operation and a 500-head hog parlor. My row crops usually include 300 acres of corn, 325 acres of soybeans, and 320 acres of wheat. This year because of the high-interest rates I only planted 175 acres of corn, 150 acres of soybeans, and 320 wheat. This is the first year I have let my land lay idle and grow up in weeds ever.

My equipment is old and wearing out rapidly but because of high costs and interest rates, I cannot afford new equipment.

Our car has 117,000 miles on it. My pickup has 112,000 miles on it. A 1-ton truck I use as a service truck on which to haul cattle has 88,000 miles on it. My 2 grain trucks have 50,000 and 70,000 miles on them, respectively. My three tractors are 1967, 1968, and 1974 models. My combine is a 1974 model.

If I am to be able to continue farming, interest rates must drop drastically, prices improve, and the weather must cooperate.

I am not able to buy much-needed equipment now. Very soon, however, my equipment is going to be completely worn out. I do not know what I will do, or whether I will be able to farm.

What the drought did to the farmer in 1980, high-interest rates are doing in 1981. The cost of borrowing money will preclude a profit on almost all operations this season. We are crippled, as interest rates have not only outstripped the farmer's ability to increase production but have also depressed prices on what yields we are able to make.

High-interest rates help the rich people and hurt the small businessman. Independent businesses, the housing industry, and farmers all depend on borrowed money.

The high-interest rate has brought the housing industry to a standstill, as these gentlemen preceding me have pointed out.

It is putting farmers out of business left and right. We can only sell at less than cost of production for so long, and then our equity is eaten away. Equity in land is the only thing that has kept farmers going in recent years, and now that is all but gone.

Thus, the high interest rates are for the rich. They can put their money in treasury bonds and so forth and draw high interest rates of 14 to 16 percent. Farming at its best pays from 2 to 6 percent on our investment in a good year.

In Georgia the last 4 years, because of drought, low prices, and high interest rates, these returns have been in the red, causing us to lose our equity.

In my case, before the drought of 1977, my net equity was approximately $700,000. Now that is all but gone, and I do not know if I will be farming next year. If I had that $700,000 in Treasury bonds for 15 percent, that would bring in $105,000 net income a year. I have never made over $20,000 net income in my life.

Since 1977, because of drought, low selling prices, and high interest rates, there have been 4 years in a row that I have lost money. This is the rule and not the exception in the Southeast and, I suspect, in the Nation as a whole.

I can tell you some of my own personal problems which are not unlike others in Georgia or nationwide. I have raised hogs all my life. I have a 500-head capacity hog parlour. I applied for a loan with the Farmers Home Administration to put in a 100-sow confinement hog operation. The local FHA man said it had been approved at the local and State level. He told me to go ahead and have my land graded and build a lagoon so I would be ready to build my hog building when the money came through.

I spent countless hours on the phone and many trips to different types of operations all across the State and Southeast. I went to the University of Georgia, North Carolina State, Auburn, Alabama, and Clemson, South Carolina. I made cost comparisons, worked many days, and spent nearly $9,000 on lagoons and grading just to be told later that they had changed their minds.

I have had many production loans approved, and I would get the money 6 months to a year after applying for them. I have gone in late fall or the winter to apply for a production loan for crops the following year. Often the money would come through that summer or fall after I had planted in the spring.

I was in a meeting in Atlanta last week with Under Secretary of Agriculture Frank Naylor. Also attending was a farmer who is a director of the Georgia Farm Bureau. He said he got his notice last week that his crop production loan for 1981 was approved. His farm is now up for sale unable to plant this year. This type of problem faces farmers all over the country.

Senator NUNN. Who was the lender in that case?

Mr. HARMAN. Farmers Home.

Until now, we have not had a Department of Agriculture. We have had a Department for Consumers. For example, the Farmers Home Administration is geared up for low-priced housing loans—not for farmers, as it was set up in the thirties.

About 75 percent of all loans in Georgia's Farmers Home are to low-cost housing and other nonfarm-related projects. In most cases, the people in the Farmers Home office know nothing about farms, farmers, or their problems.

Another problem we face in agriculture is not being free to trade where we can get the best price for our products. If Secretary Block makes a trade, or wants to, he can be cut off by Secretary Haig.

Agriculture is also hurt by high tariffs in some countries, such as Japan. It is cheaper per pound to ship a live cow to Japan than to ship processed beef because the tariffs are so high in Japan, but we allow the Japanese to saturate the car market over here.

If we get an export trade built up—for example, soybeans to Japan or corn to Russia—the President comes along and slaps an embargo on, as President Nixon and President Carter did. This causes us to be labeled as an unreliable source of products.

Japan has poured money into Brazil to make them our major competitor in recent years in growing soybeans since President Nixon's embargo. Russia is doing the same thing with corn production in Argentina since President Carter's embargo.

These problems are not caused by Republicans or Democrats but by a democracy that wants a cheap food policy. All administrations treat agriculture as if it were a red-headed stepchild.

Politicians—and I know you, Senator Nunn, do not feel that way—want a cheap food policy because that is what is best at election time. Farmers represent only 2 percent of the population and cannot elect anyone.

As an example of how the Government manipulates farmers, the commodities section of the Wall Street Journal for January 27, 1981, read as follows:

The headline on the commodity page says: "Corn must be grown to near-record pace to satisfy 1981 demand."

The Government report indicates: "If we have another bad year, we are likely to be over a barrel."

Now corn is about a dollar a bushel less than it was last year.

Cheap food policies and droughts have been our main enemies over the past years, but now high interest rates are nailing the coffin shut.

Senator NUNN. Can you make any money growing corn now at the present price?

Mr. HARMAN. No.

Senator NUNN. Can you make money on soybeans at the present price?

Mr. HARMAN. No.

Senator NUNN. What is the price of soybeans now to the farmer in Georgia?

Mr. HARMAN. Truthfully, I cannot answer for the exact price right not; but it is right at $6. I have not sold any, because my beans are not out yet.

Senator NUNN. And the corn price is what?

Mr. HARMAN. Anywhere from $2.50 to $2.60. I said a dollar. I sold some last year for over $4 a bushel.

Senator NUNN. What about wheat? Do you have any wheat for sale?

Mr. HARMAN. Maybe it would have been better—I do not know; it is a tough decision to make—but I sold all of my wheat. Last fall I planted about 310 or 320 acres of wheat. At that time, they were saying wheat was going to be over $5 a bushel. I sold it this spring and summer at $2.60 to $3.10 a bushel. Most of it was under $3 a bushel.

When you have bills to pay, you cannot store it and wait for a higher price, especially with interest rates as they are.

There are more bankruptcies, divorces, suicides, and alcoholics among Georgia farmers in the last 4 years than ever before. The field of farming is in the top three as far as stress is concerned.

In Georgia, there were 11,500 Farmers Home farm loans for $570 million in 1980 and 1981. Of these, 10,200—or $5 million—were emergency loans caused by the drought; 56 percent of these loans are delinquent; 25 percent of the regular loans are delinquent.

The Federal Land Bank-Production Credit Association of Columbia, S.C., which serves the Southeast has rescheduled 30 percent of their loans, or they would have a 30-percent delinquency rate.

In Georgia, the farm debt has risen from $1.890 billion in 1975 to $4.349 billion in 1981. In the whole United States, the farm debt has risen from $81 billion in 1975 to $168 billion in 1981.

With the debts we farmers already have, the high interest rates of our yearly production loans are making it impossible for us to survive. Farming is not capable of sustaining interest rates of over 10 percent with our cost of production and selling price as it is now and has been.

From what I understand, prime rates should not be over 12 percent—3 percent for cost of handling money and 9 percent for inflation.

I understand that the banking industry has a cushion of 7 or 8 percent in interest rates. They got hurt when interest shot up and down so much in the past. They do not want to get burned again. There is a lack of confidence in this administration, or for that matter in the last three or four administrations, that causes them to keep a cushion in their prime rate.

These high interest rates have hit farmers from both sides. High interest rates have increased the agribusiness competition for production funds with Treasury bonds, and so forth.

Agribusinessmen have higher expenses plus higher wages to pay every year. This increases the cost of their product, and the farmer must pay more and more for a combine, a tractor, fertilizer, seed, and so forth. However, we cannot pass our increased production costs along, because we cannot set a price on our products. We have to take what the consumers give us. Also, consumers are buying fewer farm products because the economy is in such bad shape.

One example of how the higher interest rates are hurting agribusiness and farmers is Gold Kist. It is a farmer co-op in the Southeast ranked in the top 500 businesses in Fortune. They paid $45 million in interest in fiscal year ending June 1981. By comparison, 2 years earlier on the same amount of capital, they paid $15 million in interest. This difference of $30 million would exceed their best year's profit on record.

This past year, Gold Kist operated at an $8 million loss. This can be directly contributed to the higher interest rate. Because of this, Gold Kist and countless other agribusinesses have had to pass along their cost increase to the farmer.

If I were buying a combine, 6 years ago I would have paid $35,000 at 8 percent with an annual payment of $7,571. The same combine today would cost me $60,000 at 16 percent and an annual payment of $16,000. The farmer just cannot sustain that kind of equipment cost. My prices have not gone up to offset this.

Corn is down $1 a bushel from last year. Cotton is down from 90 cents a pound to 60 cents a pound. Wheat is one-half the price of last year.

The average income of Georgia farmers in 1979 was $11,000. That was one of the best years ever. In 1980, the average income, due to extreme drought, low prices received, and high interest rates, it was $700 per farmer.

According to a study by an economic consulting firm in Lexington, Mass., Data Resources, Inc., "The U.S. Farm is on the Brink of Depression":

> Life on the farm is getting to look like the 1930's doldrums. The outlook for farm income and profitability has gone beyond dismal and would have to be termed catastrophic.

The implications for farms, agribusiness companies, financial institutions, and the economy as a whole are serious indeed.

When the family farm is forced out of business, conglomerates are going to take over farming. Then the consumer will really see high food prices. They will control the food supply and the cost of food.

For example, Tenneco now owns 11 million acres in just California and Arizona alone. Tenneco is the largest shipper of table grapes in the country. They ship 15 percent of all grapes produced, 25 percent of all almonds, and 40 percent of the pistachioes.

Senator NUNN. Where did these statistics come from, Ned?

Mr. HARMAN. I got this from the Atlanta Journal and Constitutional Sunday paper from their business section.

Senator NUNN. I had not seen those before. That is very interesting.

Mr. HARMAN. Another example of conglomerates taking over farming is Occidental Petroleum buying out Iowa Beef. This was in a Wall Street Journal article the other day.

Iowa Beef is the Nation's largest beef processor.

Armand Hammer said food will be in the 1990's what oil is in the 1980's.

I believe in the long run that this administration's policies are basically good, except for the business of farming. As these gentlemen pointed out, there are some other businesses in bad shape too.

Consumers will have to pay much higher food prices in the near future.

It is like a cartoon I saw the other day of a doctor who performed a perfect operation, but the patient died. I feel that is what the administration is doing to some segments of the economy now. That is what the farmer's situation is—I know that for a fact.

Farmers are the most patriotic and most willing to sacrifice people in the Nation. However, I ask you: What can we do now? We have given all we have to give.

We as farmers are not asking for a free ride in life. We are just asking for a chance to survive. The aid we have received is most appreciated, but you cannot use a band-aid to save a man who has been split open from head to foot by financial disaster.

This is the condition of agriculture. We are the lowest paid public servants in the country.

We give the country the export trade to pay for our OPEC oil. We give you the cheapest and finest food in the world. Agriculture is the Nation's biggest industry with assets totaling $927 billion, or 88 percent of the capital assets of all manufacturing corporations in the United States.

We give the world 43 percent of its wheat exports, 62 percent of coarse grain exports, and 52 percent of total exports of oilseed.

With half a billion people suffering from malnutrition today and with the world population expected to increase 50 percent in 20 years, we give the only hope to prevent wholesale starvation. That means more sophisticated and expensive farming equipment, and that means higher farm debt.

Farmers Home and SBA have loaned us some money, but they will not let us alone long enough to try to pay it back.

Instead, the Government gives us a commercial system where we have no choice on the price we pay for equipment and supplies. Then the Government gives us a board of trade marketing system that allows us no choice for what we will be paid for our products. This may be our last chance, but we will keep fighting as long as we are alive and out of debtor's prison.

We need to overhaul our farm credit programs by allowing repayment flexibility for farm borrowers during hard times. We need new financing for irrigation—the best drought insurance money can buy. We must improve all of our basic commodity programs in a comprehensive way so that the family farm can survive inflation and market instability.

There is no better hope for the people of this Nation and this Earth than for the continued viability of the independent, family-owned, and family-operated American farm.

Thank you.

Senator NUNN. Thank you very much, Ned. I agree with every word you said here, and I certainly agree with you on the scope of the problem.

Did you follow the agriculture bill that was on the floor last week? Have you had a chance to study the results of that?

Mr. HARMAN. No, sir, not in great detail. I just know a few of the details. I have not had a chance to study it though.

Senator NUNN. It came out of the committee within the budget that we had set. Then it got scaled down and scaled down. This is the first time since I have been in the Senate that I voted against a farm bill.

The commodity price supports, and so forth, are just woefully inadequate, considering the cost of production and considering the risk that farmers are taking and the desperate situation they are in.

I am hoping that the House will improve it. It will be the first time though that the House has ever improved a Senate bill, as far as the farmers are concerned. It usually is the other way around.

I share your sense of alarm about what is happening in the farming community.

Let me ask you this question: Is the tax cut really going to help many farmers at this stage?

Mr. HARMAN. No, sir. It is not going to help me and the people I represent in the Young Farmers organization.

The biggest majority of them are not paying any tax now, because we are at a loss. Most of them are about to go bankrupt. We do not need to pay tax, because we are on the losing end.

Senator NUNN. If you had a choice between the tax cut and having the prime rate come down to ten or twelve percent, which would you choose?

Mr. HARMAN. Ten or twelve percent, for sure.

Senator NUNN. You think that would be the case of most farmers in Georgia?

Mr. HARMAN. Yes, sir; I know it would.

Senator NUNN. We have a real crack in the economy. The farm economy, I think, is the most vulnerable of all—even more vulnerable right now than some of the others. Housing and automobiles are certainly vulnerable. Thrift institutions are vulnerable.

You are not alone, but you have had the culmination of not just interest rates but you have had droughts and very low commodity prices.

Mr. HARMAN. That is right.

Senator NUNN. Interest rates are on top of what was already a foundation of huge woes.

I do not know any easy answers.

Some of the members of the committee had to leave, but I think most of them have read or will read your testimony. We are going to do all we can.

We appreciate very much your being here today, Ned.

Mr. HARMAN. Thank you, Senator Nunn.

[The prepared statement of Mr. Harman follows:]

Gentlemen, I'm Ned Harman. I'm 36 years old. I live near Carrollton, in Northwest Georgia. I am married and have 5 children. My family operation consist of 1000 acres owned and rented. I have a 175 beef cow calf operation, a 500 head hog parlor. My row crop operation icludes 300 acres of corn, 325 acres of soybeans and 320 acres of wheat. This year because of high interest rates I only planted 175 acres of corn and 150 acres of soybeans. This is the first year I have let land lay idle and grow up in weeds.

My equipment is old and wearing out rapidly but because of high cost and interest rates I cannot afford new equipment. Our car has 117,000 miles on it, my pickup has 112,000 miles, a ton truck used as a service truck has 88,000 miles, my 2 grain trucks have 50 and 70 thousand miles on them. My three tractors are 1967, 1968 and 1974 models. My combine is a 1974 model. If I am able to continue farming, unless interest rates must drop drastically, prices improve and the weather cooperate. I am now not able to buy much needed equipment. Very soon however my equipment is going to be completely worn out.

What the drought did to the farmers in 1980, high interest rates are doing in 1981. The cost of borrowing money will preclude a profit on almost all operations this season. We are crippled as interest rates have not only outstripped a farmer's ability to increase production but have also depressed prices on what yields we are able to make.

High interest rates help the rich people and hurt the small businessman. Independent business, the housing industry, and farmers all depend on borrowed money. This high interest rate has brought the housing industry to a stand still It is putting farmers out of business, left and right. We can only sell at less than cost of production so long, and then our equity is eaten away. Equity in land is the only thing that has kept farmers going in recent years and now that is all but gone. Thus, the high interest rates are for the rich. They can put their money in Treasury bonds, etc., and draw high interest rates of 14-16%. Farming at it's best, pays from 2-6% on our investment in a good year.

In Georgia, the last 4 years, because of drought, low prices and high interest rates, these returns have been in the red causing us to lose our equity. In my case, before the drought of 1977, my net equity was approximately $700,000. Now that is all but gone and I don't know if I will be farming next year. If I had that $700,000 in Treasury bonds for 15%, that would bring in $105,000 net income.

I have never made over $20,000 net income in my life. Since 1977, because of drought, low selling prices, and high interest rates, there have been 4 years in a row that I have lost money. This is the rule and not the exception in the Southeast and, I suspect, in the nation.

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$9,000 on lagoons and grading just to be told later that they had changed their minds.

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These problems are not caused by Republicans or Democrats, but by a democracy that wants a cheap food policy. All administrations treat agriculture as if it were a red-headed stepchild.

Politicians, such as yourself, gentlemen, want a cheap food policy because that is what is best for you at election time. Farmers represent only 2% of the population and can not elect anyone.

As an example of how the government manipulates farmers, the commodities section of the Wall Street Journal for January 27, 1981, read as follows: HEADLINE: "Corn must be grown to near-record pace to satisfy '81 demand." Government report indicates "If we have another bad year, we're likely to be over a barrel."

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I believe in the long run this administration's policies are basically good except for the business of farming. Consumers will have to pay much higher food prices in the near future. It's like the doctor who performed a perfect operation but the **patient** died. That's the farmer's situation. Farmers are the most patriotic and most willing to sacrifice people in the nation but, I ask you, what can we do now? We have given all we can give.

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There is no better hope for the people of this nation and this earth than for the continued viability of the indepent, family-owned and family-operated American farm. Thank you.

Senator NUNN. Senator Weicker has asked me to close the hearing at this point in time.

We want to thank all our witnesses for appearing here today. Thank you all.

[Whereupon, at 11:40 a.m., the committee recessed, to reconvene subject to call of the Chair.]

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